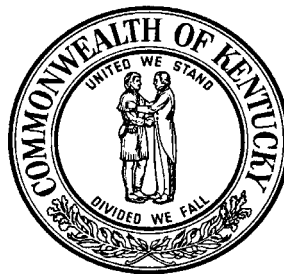


**LETTER FROM THE AUDITOR OF PUBLIC ACCOUNTS
FINANCE AND ADMINISTRATION CABINET**

**In Reference to the Statewide Single Audit
of the Commonwealth of Kentucky**

**For the Year Ended
June 30, 2005**



**CRIT LUALLEN
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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

To the People of Kentucky
Honorable Ernie Fletcher, Governor
John Farris, Secretary
Finance and Administration Cabinet

MANAGEMENT LETTER

KRS 43.090 (1) requires the Auditor of Public Accounts, upon completion of each audit and investigation, to prepare a report of all findings and recommendations, and to furnish copies of the report to the head of the agency to which the report pertains, and to the Governor, among others. This KRS also requires the Finance and Administration Cabinet (FAC) to, within 60 days of the completion of the final audit, notify the Legislative Research Commission and the Auditor of Public Accounts of the audit recommendations it has implemented and those it has not implemented and any reasons therefore. We are providing this letter to FAC in compliance with KRS 43.090.

The work completed on FAC is part of the overall opinions included in the audit of the Commonwealth of Kentucky's Comprehensive Annual Financial Report (CAFR) and Statewide Single Audit of Kentucky (SSWAK). Findings and recommendations for agencies, audited as part of the CAFR and SSWAK, if applicable, can be found in the Statewide Single Audit Report. This report can be obtained on our website at www.auditor.ky.gov.

In planning and performing our audits of the Commonwealth for the year ended June 30, 2005, we considered FAC's internal control over financial reporting and compliance with laws, regulations, contracts and grant agreements in order to determine our auditing procedures for the purpose of expressing opinions included in the audit of the CAFR and SSWAK and not to provide an opinion on internal control or on compliance.

However, during our audit we became aware of certain matters that are opportunities for strengthening internal controls and operating efficiency. The SSWAK is a separate report dated March 9, 2006 and contains all reportable conditions and material weaknesses in the Commonwealth's internal control structure and also contains all reportable instances of noncompliance. This letter does contain FAC findings and our recommendations that have been extracted from the SSWAK report along with other matters that have been identified.



To the People of Kentucky
Honorable Ernie Fletcher, Governor
John Farris, Secretary
Finance and Administration Cabinet

We will review the status of these comments during our next audit. We have already discussed many of these comments and suggestions with various FAC personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Included in this letter are the following:

- ◆ Acronym List
- ◆ Schedule of Expenditures of Federal Awards
- ◆ Notes to the Schedule of Expenditures of Federal Awards
- ◆ Findings and Recommendations
- ◆ Summary Schedule of Prior Year Audit Findings

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen", with a long horizontal flourish extending to the right.

Crit Luallen
Auditor of Public Accounts

Audit fieldwork completed -
March 9, 2006

LIST OF ABBREVIATIONS/ACRONYMS

AFR	Annual Financial Reporting Form
AOC	Administrative Office of the Courts
APA	Auditor of Public Accounts
CAFR	Comprehensive Annual Financial Report
CAMRA	Complete Asset Management Reporting and Accounting
CC	Contract Compliance
CFDA	Catalog of Federal Domestic Assistance
Commonwealth	Commonwealth of Kentucky
COT	Commonwealth Office of Technology (Formally known as GOT)
CPA	Certified Public Accountant
CRC	Finance and Administration Cabinet Customer Resource Center
CUSIP	Committee on Uniform Security Identification Procedures
CY	Current Year
DMS	Department for Medicaid Services
EEO	Equal Employment Opportunity
eMARS	enhanced Management Administrative Reporting System
FA	Fixed Assets
FAC	Finance and Administration Cabinet
FAP	Finance and Administration Policy
FAS	Financial Analysis System
FHS	First Health Services
Finance	Finance and Administration Cabinet
FP	Form of Proposal
FTP	File Transfer Protocol
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GASB	Governmental Accounting Standards Board
GOPM	Governors Office for Policy & Management
ID	Identification
IRS	U. S. Internal Revenue Service
IT	Information Technology
JV	Journal Voucher
KMAA	Kentucky Medicaid Administrative Agent
KRS	Kentucky Revised Statute
KTRS	Kentucky Teachers Retirement System
KY	Kentucky
LLC	Limited Liability Company
MARS	Management Administrative Reporting System
MISC	Miscellaneous
MMIS	Medicaid Management Information System
MRDB	Management Reporting Database
MSADC	Microsoft Active Directory Connector
N/A	Not Applicable
OFM	Office of Financial Management
OMB	Office of Management and Budget
OMPS	Office of Material and Procurement Services

LIST OF ABBREVIATIONS/ACRONYMS
(Continued)

PBU	Program Budget Unit
PCR	Program Change Request
PD	Procurement Desktop
PDC	Primary Domain Controller
PNC	Provident National Corporation
RFB	Request for Bid
RFI	Request for Information
RFP	Request For Proposal
RQ	Purchase Requisition
SAS	Statistical Analysis System
SEFA	Schedule of Expenditures of Federal Awards
SFAC	Statement of Financial Accounting Concepts
SOP	Standard Operating Procedure
SSL	Secure Socket Layer
SWCAP	Statewide Cost Allocation Plan
TRAN	Tax Revenue Anticipation Note
US	United States
VIS	Visa Information Source
YR	Year

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FEDERAL ASSISTANCE PROGRAMS
FOR THE YEAR ENDED JUNE 30, 2005

CFDA # Program Title	State Organizations	Expenditures		Provided to Subrecipient
		Cash	Noncash	
FINANCE AND ADMINISTRATION CABINET				
U.S. Appalachian Regional Commission				
Direct Program:				
23.011	Appalachian Research, Technical Assistance, and Demonstration Project	\$ 37,987	\$	\$37,987
U.S. General Services Administration				
Direct Program:				
39.003	Donation of Federal Surplus Personal Property (Note 3)		759,660	
U.S. Department of Health and Human Services				
Direct Program:				
93.585	Empowerment Zones Program	490,926		490,926
TOTAL FINANCE AND ADMINISTRATION CABINET		\$ 528,913	\$ 759,660	\$ 528,913

NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2005

Note 1 - Purpose of the Schedule and Significant Accounting Policies

Basis of Presentation - OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, requires a Schedule of Expenditures of Federal Awards showing each federal financial assistance program as identified in the *Catalog of Federal Domestic Assistance*. The accompanying schedule includes all federal grant activity for the Finance and Administration Cabinet, except those programs administered by state universities, and is presented primarily on the basis of cash disbursements as modified by the application of KRS 45.229. Consequently, certain expenditures are recorded in the accounts only when cash is disbursed. The Commonwealth elected to exclude state universities from the statewide single audit, except as part of the audit of the basic financial statements.

KRS 45.229 provides that the Finance and Administration Cabinet may, “for a period of thirty (30) days after the close of any fiscal year, draw warrants against the available balances of appropriations made for that fiscal year, for the payment of expenditures incurred during that year or in fulfillment of contracts properly made during the year, but for no other purpose.” However, there is an exception to the application of KRS 45.229 in that regular payroll expenses incurred during the last pay period of the fiscal year are charged to the next year.

The basic financial statements of the Commonwealth are presented on the modified accrual basis of accounting for the governmental fund financial statements and the accrual basis of accounting for the government-wide, proprietary fund, and fiduciary fund financial statements. Therefore, the schedule may not be directly traceable to the basic financial statements in all cases.

Noncash assistance programs are not reported in the basic financial statements of the Commonwealth for FY 2005. The noncash expenditures presented on this schedule represent the noncash assistance expended using the method or basis of valuation described in Note 3.

Inter-Agency Activity - Certain transactions relating to federal financial assistance may appear in the records of more than one (1) state agency. To avoid the overstatement of federal expenditures, the following policies were adopted for the presentation of the schedule:

- (a) Federal moneys may be received by a state agency and passed through to another state agency where the moneys are expended. Except for pass-throughs to state universities as discussed below, this inter-agency transfer activity is reported by the agency expending the moneys.

State agencies that pass federal funds to state universities report those amounts as expenditures.

NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2005

Note 1 - Purpose of the Schedule and Significant Accounting Policies (Continued)

Inter-Agency Activity (Continued)

- (b) Federal moneys received by a state agency and used to purchase goods or services from another state agency are reported in the schedule as an expenditure by the purchasing agency only.

Note 2 - Type A Programs

Type A programs for the Commonwealth mean any program for which total expenditures of federal awards exceeded \$20 million for FY 2005.

The Finance and Administration Cabinet had no programs that met the Type A program definition for FY 2005.

Note 3 - Noncash Expenditure Programs

FAC's noncash program and a description of the method/basis of valuation follows:

CFDA #	Program Title	Amount	Method/Basis of Valuation
39.003	Donation of Federal Surplus Personal Property	\$759,660	23.3% of federal acquisition cost (\$3,260,343).

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-01: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System

During the audit of the internal controls over the Commonwealth's Cash and Investments System, we noted that the Office of Financial Management (OFM) has a program modification process in place; however, this process had not been formalized in standards or procedure statements specific to the agency. Further, as has been reported for the last three years, although agency personnel are aware of the program modification process, it is not being consistently applied to new program development and changes to existing programs.

To help standardize the program modification process, OFM has developed a program modification request form called a Program Change Request (PCR). Among the steps associated with this form, approvals are required from various members of agency personnel to ensure that the requested change is necessary, the proposed coding change is reasonable, and the altered program code has been sufficiently tested for accuracy and applicability to the requested change. Once all of these approvals have been placed on the PCR, then a final approval to move the change into production must be applied.

The review of documentation maintained in support of the program modification process revealed that there was no central repository or logging of PCR requests that are within this program modification process. We found two complete PCR requests that had been promoted to production within the possession of one or more of these individuals: the programmer, the internal auditor, and the librarian for the production environment. Also, after asking about new program development, there was an additional complete PCR form presented to the auditor for a change moved into production on July 1, 2004, which had not been in the possession of any of these individuals during the testing phase.

During testing for FY 2005, we identified 608 instances where changes were made within 28 programs. Of these changes, there were 156 instances, or 25.7 percent, that were not supported by a PCR or considered a 'general maintenance' change.

As discussed with the agency during the FY 2003 audit and thereafter, a 'general maintenance' PCR may be used for routine program changes, which can include changes to the cycle number, fiscal year, date, number of days in the month, and file name changes where the file name contains a date or month that corresponds to the date/month being processed. There were 430 'general maintenance' changes identified within the 608 instances of changes for FY 2005, or 70.7 percent, that the auditor would consider meeting the requirements of a general maintenance program change. These changes were not supported by e-mail or other communication of the issues to be resolved, a code comparison that shows all changes made to the program, or proper approval from a person other than the programmer to move the changes into production.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-01: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System (Continued)

A review of the PCR forms and supporting documentation revealed that there is no listing consistently developed that specifically discusses or shows the changes that were made in the program code. None of the 3 FY 2005 complete PCR forms included a code comparison between the original code and the revised code. Therefore, we were only able to trace changes based on the descriptions on the form of the proposed changes.

Also, the prior year review of the completed PCR forms revealed a significant number of changes being placed into the production environment before receiving the final approval for implementation. For FY 2005, one of the three, or 33.3%, completed PCR forms were exceptions. This PCR represented a change request where a program was placed in production nearly a month prior to the approval to proceed with changes and over seven months prior to the approval for implementation.

Our discussions with the production environment librarian indicated that due to a lack of required documentation, program changes could be placed into production without proper approval for implementation. Agency personnel had informed the librarian that the only requirement for uploading programs into the production environment was an e-mail message from the programmer. Further, the librarian does not participate in the completion of the PCR form, although there is a section on the form that is to be filled out by the person that has implemented the change to production. This particular request concerned an initiative by OFM to modify existing programs and develop any necessary new programs to ensure that the cash within the portfolio accounts could be matched between the Commonwealth's financial system and the Cash & Investments System.

During discussions with the librarian over the production environment, it was discovered that due to a lack of documentation required, program changes could be placed into production without proper approval for implementation. Agency personnel had informed the librarian that the only requirement for uploading programs into the production environment was an e-mail message from the programmer. Further, the librarian does not participate in the completion of the PCR form, although there is a section on the form that is to be filled out by the person that has implemented the change to production.

Without a formalized program modification process and monitoring of the compliance with the process, the agency is at risk that procedures that are deemed vital to the process will be overlooked. For example, disregarding the procedure established to review supporting documentation for evidence that a change has been tested and approved for promotion to production could circumvent the control that only allows the librarian to have write access to the production environment. This increases the likelihood that unauthorized or inappropriate program changes could be placed in production.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-01: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System (Continued)

The program modification process should be formalized, distributed, and understood by all applicable agency personnel. This process should be consistently applied to all code changes to existing programs and the development of new programs.

Due to a change in the timing of the auditor's review of certain IT processes and controls, the testing of FY 2005 IT processes and controls was conducted prior to the agency having an opportunity to remedy the issues identified in the FY 2004 report comments.

Recommendation

We recommend that OFM formalize, implement, and consistently apply control procedures over the program modification process. Specifically, the agency should, at a minimum:

Develop a formal procedure manual for the program modification process. This manual should include the procedures to adequately document program specifications and understanding of program objectives, to specifically identify changes in code by developing a code comparison listing between the original code and the revised code, to properly complete the PCR form, to adequately test proposed program code changes, and to verify that all approvals are in place for the program code change before implementation to the production environment. If emergency situations are anticipated that might require this process to be accelerated, then that should be taken into consideration and an alternative process developed that properly applies compensating controls over that accelerated process.

- Process all new programs and modifications to existing programs through the established program modification process as documented in the formal procedure manual.
- Ensure all changes comply with established program modification procedural requirements. Requirements should include procedures to ensure that all changes are properly reviewed for accuracy by an individual other than the programmer and that proper approvals are documented authorizing implementation of the change into production before the librarian moves the change to the production environment. After implementation of changes, the librarian should sign and date the PCR form to affirm that this process has been completed.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-01: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System (Continued)

- Ensure, for those changes that relate to a 'general maintenance' PCR form, that the programmer provides supporting documentation for the request of the program changes, inclusive of an e-mail or other communication of the issues to be resolved, identification of the specific program code that was changed to satisfy the request, and approval from a person other than the programmer to move the changes into production. All personnel involved with authorizations of the PCR form should be made aware of the responsibilities they are assuming with their authorizations on these forms.
- Establish a logging feature within the program modification process. This log should include the name of the originator, origination date, brief description of problem, programs affected, completion date, and implementation date.
- Establish a centralized location for maintaining all complete PCR forms.

We are aware that the agency has begun the process to replace the current Cash and Investments System; however, we believe that the recommendations proposed are universal enough to relate easily with the new system development. It is the historical precedent within OFM to require continuous program changes that has caused the auditors to strongly advocate the agency formalize and consistently apply appropriate program change control procedures.

Management's Response and Corrective Action Plan

The Office of Financial Management agrees the Program Change Request is not being completed as required. We are currently in the process of writing a new program. This will eliminate the need to make any updates to the old SAS program. Once the new program is in place, all program files will be placed in the Library. Any change to the file will require approval of the Accounting/IT supervisor. The Librarian will be instructed to move the files after the supervisor has approved. Once the new program is complete, a formalized process for program changes will be completed and implemented. The new month end program will run through LanBatch, therefore the program changes will not be implemented until approved by the supervisor and moved to the Library.

We will establish a logging procedure for program change requests and have one documentation file that will have all signed reports.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-02: The Finance And Administration Cabinet Should Strengthen Logical Security Procedures Surrounding The Complete Asset Management, Reporting, And Accounting System

As noted during the previous audit of the Commonwealth's Cash and Investments System, the Office of Financial Management did not properly secure the critical financial data associated with the distribution of earnings from investments. Further, OFM has not developed or implemented a formalized security policy that identifies management and user responsibilities concerning IT security surrounding the Cash and Investments System.

By moving all production programs into a secured file directory that is restricted to the Librarian and the Commonwealth Office of Technology administrators, OFM has increased the security over the system programs. However, the auditors found a significant number of files, including production data files, being used within current system programs that reside in another directory that is not as strictly secured. Also within this directory is the staging libraries used by the programmer to hold programs waiting to be moved to production. All OFM staff currently has 'Change' access to these files, which would allow them to read, add, alter, or delete these files.

Without strong, formalized, logical security controls, the opportunity increases for unauthorized modification to production files as well as the likelihood of errors or losses occurring from incorrect use of data and other resources.

Due to a change in the timing of the auditor's review of certain IT processes and controls, the testing of FY 2005 IT processes and controls was conducted prior to the agency having an opportunity to remedy the issues identified in the FY 2004 report comments.

Formalized security policies set the tone of management concern for strong system security and provide a security framework used to educate management and users on their responsibilities. Further, access to directories that house programs and critical financial data should be restricted to only necessary employees. System security should be administered in such a way as to ensure proper segregation of duties. Granting users system access that would allow the ability to alter or delete programs or financial data prior to or subsequent to processing increases the risk of financial misstatements or fraudulent reporting.

Recommendation

We recommend that OFM develop and implement a formalized security policy that standardizes security responsibilities for all employees and ensures critical programs and data are properly secured. All Cash and Investment System related programs should be reviewed to ensure that financial data files being used or created are being housed in a properly secured directory. Further, access to the program staging library should be properly restricted.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-02: The Finance And Administration Cabinet Should Strengthen Logical Security Procedures Surrounding The Complete Asset Management, Reporting, And Accounting System (Continued)****Management's Response and Corrective Action Plan**

A formalized policy will be written and implemented during FY 2006. We are in the process of writing a new program and the security policy will reflect that program. Beginning with FY 2006, all program files will be maintained in the Library. The only time the files will be moved/changed is when a program change request has been submitted and approved. After the programmer makes the change, the files will be placed in a secure folder. The folder will have security to allow only the supervisor to have write access. Once the files have been reviewed and approved by the supervisor the Librarian will be contacted to move the files into the Library.

FINDING 05-FAC-03: The Finance And Administration Cabinet Should Ensure That Securities Lending Assets, Liabilities, Revenues, And Expenditures Are Reported In Funds Sharing The Risk Of Loss

As of June 30, 2005, the Commonwealth had \$1,018,436,031 of securities lending assets and liabilities. The Commonwealth earned over \$25,190,903 in securities lending income and also incurred this amount of rebates and securities lending agent fees during FY 2005. The Finance and Administration Cabinet recorded this activity via a journal voucher in the General Fund. However, these assets and liabilities should have been reported in the balance sheets of the funds that have the risk of loss. Therefore, \$804,564,465 of the securities lending assets/liabilities and \$19,900,813 of the securities lending income/expenses (or 79%) had to be subsequently reclassified to the other funds that shared the risk of loss.

The securities lending assets and liabilities and related income and expenses were likely recorded in the General Fund as a result of a misunderstanding of the GASB requirements. If this had not been detected, the General Fund's assets and liabilities would have been overstated by \$804,564,465 and the income/expenses would have been overstated by \$19,900,813. The assets/liabilities and revenue/expenses for the funds sharing the risk of loss would have been understated (in aggregate) by these same amounts.

Paragraphs 9 and 10 of GASB 28 - *Accounting and Financial Reporting for Securities Lending Transactions* state, "If a government pools money from several funds for investment purposes and the pool, rather than the individual funds, has securities lending transactions, the government should report the assets and liabilities arising from the

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-03: The Finance And Administration Cabinet Should Ensure That Securities Lending Assets, Liabilities, Revenues, And Expenditures Are Reported In Funds Sharing The Risk Of Loss (Continued)

securities lending transactions in the balance sheets of the funds that have the risk of loss on the collateral assets. In many cases, this will involve a pro rata allocation to the various funds based on their equity in the pool. Similarly, the income and costs arising from pooled securities lending transactions should be reported in operating statements of the funds”.

Recommendation

We recommend FAC report the securities lending assets/liabilities and related income/expenses in the funds that share the risk of loss.

Management’s Response and Corrective Action Plan

The Financial Reporting Team will continue to report Securities Lending Transactions in accordance with GASB standards.

FINDING 05-FAC-04: The Finance And Administration Cabinet Should Perform A Periodic Review Of Transactions Approved By The “Superusers” And Agency MARS Administrators

The Finance and Administration Cabinet has granted a select group of individuals special approval authority of transactions in MARS. These users (hereafter referred to as superusers) have a wide range of authority including being able to remove lower level approvals, make changes to original documents, and then apply all levels of approvals so the document can be processed. Apparently, having this authority is a necessary part of performing their job responsibilities. FAC, however, has not developed procedures to conduct periodic reviews of the transactions processed by either the superusers or the Agency MARS Administrators.

Given the wide range of authority that these select individuals have, if their transactions or approvals are not reviewed periodically by an independent third party who reports to upper management, there is an increased risk that a superuser or Agency MARS Administrator could commit fraud and/or illegal acts and it remain undetected.

Good internal controls dictate that all transactions be properly authorized and that no single user has the ability to enter and approve (or remove lower levels of approvals, make changes, and then apply all approvals to) a transaction in the accounting system. Since this option is not always available, compensating controls, such as periodic reviews by upper management, must be in place to mitigate this risk to an acceptable level.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-04: The Finance And Administration Cabinet Should Perform A
Periodic Review Of Transactions Approved By The “Superusers” And Agency
MARS Administrators (Continued)**

Recommendation

We recommend that the Finance and Administration Cabinet:

- Review transactions and all supporting documentation processed/approved by superusers or Agency MARS Administrators from FY 2005 forward to ensure the necessity and appropriateness of the transactions.
- Create a new set of USER IDs for superusers and all Agency MARS Administrators. Since the superuser/MARS Administrator authority is likely not needed for daily transactional processing, Finance should create a new set of USER IDs so that each user has two MARS IDs. Their current ID could be used for special processing and a limited ID (new ID with all the normal approval limitations) could be used for their normal daily transactions.
- Require an independent third party conduct annual audits or reviews of superuser/Agency MARS Administrator transactions to ensure the necessity and appropriateness of the transaction and correct application of the superuser/Administrator approvals. Documentation of this review should be maintained.
- Inform the APA of the findings of the historical document review and the annual reviews of these approvals.

Management’s Response and Corrective Action Plan

We agree that an enhanced control structure related to super-users should exist. As noted, these users have a wide range of approval authority, which is necessary for the performance of job duties related to various types of financial transactions. Given the nature of this approval, we have from time to time conducted limited reviews of super-user transactions. We plan to continue conducting periodic reviews, and will summarize the results at the end of each year. This information will be available to APA, upon request.

Expending resources to create separate USER IDs may not be advantageous at this point however, since EMARS will be used for FY07. EMARS will include various controls to prevent users from changing original approvals and then resubmitting documents.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-05: The Governor's Office For Policy And Management Should Provide Complete And Accurate Guidance Regarding Investment Income

Part of our testing procedures for the investment income audit included a review of the statutory authority for accounts receiving investment income within the State Investment Pool. The Governor's Office for Policy and Management (GOPM) documents this statutory authority on the SAS-14 form. We randomly selected 30 MARS cash accounts for testing and requested the applicable SAS-14 forms. From this sample, we noted the following weaknesses:

- 1) Two SAS-14 documents did not list the statutory authority for two cash accounts that receive investment income. (6.67% of sample)
- 2) GOPM could not locate two SAS-14 forms documenting the authority to receive investment income (6.67% of sample).
- 3) Of the two accounts where a SAS-14 form could not be produced, guidance from GOPM indicated that KRS 42.450 was the statutory authority for these accounts to receive investment income. Our research indicated that the actual guidance/authority is KRS 42.4582.

In the prior year audit, we noted similar problems such as not having statutory references for all accounts entitled to receive investment income and not having specific statutory references on the SAS-14 form.

In addition, we noted instances where the SAS-14 form had not been signed by or receipt acknowledged by the agencies involved. Without assurance that the agency has received their SAS-14, it is possible that the account owners might not be aware of the changes made to their accounts.

Without adequate internal controls to ensure the correctness of the SAS-14 an account could receive income that it is not entitled to receive and thus violate KRS regarding how an account's cash should be invested and/or which account should receive the investment income.

Management should have adequate internal controls in place to provide reasonable assurance that investments and subsequent posting of investment income is in compliance with applicable laws and regulations.

Recommendation

We recommend GOPM:

- Provide detailed statutory references for all accounts entitled to receive investment income
- Prepare SAS-14 forms for all new cash accounts and account updates

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-05: The Governor's Office For Policy And Management Should Provide Complete And Accurate Guidance Regarding Investment Income (Continued)

- Maintain a log of the statutory authority and investment restrictions by MARS cash account or maintain adequate supporting documentation so that accurate guidance can be provided to the Office of Financial Management or other parties
- Develop procedures to ensure all SAS-14 account changes are signed or acknowledged by agency account owners

Management's Response and Corrective Action Plan

This Office appreciates the efforts of the Auditor of Public Accounts in reviewing the procedures of determining the accrual of interest income to those accounts with such authority. This Office takes pride in implementing the laws of the Commonwealth, the Federal government, and the responsibilities of playing a role in the stewardship of the financial resources devoted to the public good.

The findings involve the process of establishing accounts within the Commonwealth's accounting system. By policy the Office of the State Budget Director is responsible for approving all chart of account establishments that involve an appropriation account, an allotment account, and a program budget unit (PBU) account. Also, by policy, the Office of the State Budget Director is responsible for approving the accrual of interest income for accounts that have such authority. In that process the Office requires a documentation of the underlying authority for the accrual of interest income when establishing such an account. The form approved by the Office of the Controller within the Finance and Administration Cabinet for this process is the SAS-14 form. On that form is a memo field for the purpose of documenting the authority for an account's accrual of interest income, where an appropriate statute, regulation, federal law or rule, or other authority is documented.

Condition (Nature of the Weakness or Noncompliance):

- 1) *The statutory authority for two (2) accounts that receive investment income was not listed (6.67%).*

Response: *Agreed. The staff of the Office of State Budget Director has been verbally reminded of this mandatory requirement. The Accounting unit of this Office will continue to monitor this requirement.*

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-05: The Governor's Office For Policy And Management Should Provide Complete And Accurate Guidance Regarding Investment Income (Continued)

- 2) A SAS-14 form could not be produced for two (2) other accounts that have statutory authority to receive investment income (6.67%).

Response: Without knowing exactly which accounts this condition references, there were accounts for which the SAS-14 were requested that were at least seven years old. The custodian of these completed forms is within the Finance and Administration Cabinet, and the location of the forms of that age and older is likely within the state's archives files. This fact was made known to the Auditor of Public Accounts at the time it was requested.

- 3) Of the two (2) accounts where a SAS-14 form could not be produced, guidance from GPM indicated that KRS 42.450 is the statutory authority for these accounts to receive investment income. Further investigation revealed that the actual guidance/authority is KRS 42.4582.

Response: An error in a statutory reference was given in an e-mail exchange. This error should not rise to the level of a statement of weakness or noncompliance when the accounts in question were properly accruing and receiving interest income.

Auditor of Public Accounts' Recommendations:

Recommendation #1 – detailed statutory references (not just KRS or IRS) be provided for all accounts entitled to receive investment income.

Response: The Office of State Budget Director agrees with the recommendation, with the exception that not all of the references are statutory. The only instances in which a federal Internal Revenue Service reference is used is when an account contains tax-exempt bond funds in which IRS arbitrage regulations govern the accrual of interest income on account balances. The Office of State Budget Director's Accounting unit staff is responsible for ensuring that the legal authority field is completed for an account that accrues interest income.

Recommendation #2 - SAS-14 forms be prepared for all new cash accounts and account updates.

Response: The Office of State Budget Director agrees with the recommendation, and this recommendation is already standard operating procedure for establishing new cash accounts and account updates. To this Office's knowledge, no new cash account or account updates were implemented without an associated SAS-14 form.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-05: The Governor's Office For Policy And Management Should Provide Complete And Accurate Guidance Regarding Investment Income (Continued)

Recommendation #3 – GOPM maintain a log of the statutory authority and investment restrictions by MARS cash account or maintain adequate supporting documentation so that accurate guidance can be provided to the Office of Financial Management or other parties.

Response: The Office of State Budget Director agrees with the recommendation to maintain a log of statutory authority. The Office of State Budget Director's Accounting unit staff will be responsible for maintaining the log of statutory authority. Any restrictions on investments are the responsibility of the Finance and Administration Cabinet's Office of Financial Management.

Recommendation #4 – all SAS-14 account changes should be signed or acknowledged by agency account owners.

Response: The Office of State Budget Director respectfully disagrees with this recommendation. It is the Office of the State Budget Director's responsibility to approve the chart of account establishments and changes for appropriation, allotment, and program budget unit (PBU) elements. All other chart of account elements are the responsibility of state agencies, or in some instances, the Office of the Controller within the Finance and Administration Cabinet. It is typical that state agencies initiate chart of account establishments and changes, but it is not always the case. The agency is not the sole owner of these accounts; otherwise this Office's approval would not be a part of the process. From the standpoint of internal control, the entity with the responsibility to approve the chart of account elements, the Office of State Budget Director, is the entity that expresses its approval on the SAS-14 form. There is a variety of means for agencies to be informed and understand any and all chart of account establishments and changes; whether initiated by them or not. The SAS-14 form is but one of them.

Auditor's Reply

We appreciate the time and detailed response provided by the GOPM. We would like to provide the following clarifications and responses:

- 2) The SAS-14 forms in question related to account updates from FY 2004 where a SAS-14 form could not be produced for these account changes. Instead an email was provided that states, "Consider this a backup for a blanket SAS-14 for these changes." We could see how an email would be sufficient if it contained all of the necessary information that is contained on the SAS-14 form. This email, however, did not provide 1) the statutory authority governing these accounts and 2) evidence showing where the account owners were notified of the account changes. The importance of this is discussed under #4 below.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-05: The Governor's Office For Policy And Management Should
Provide Complete And Accurate Guidance Regarding Investment Income
(Continued)**

Auditor's Reply (Continued)

- 3) We agree that interest was credited to the proper accounts; however, the control weakness comes from the fact that all guidance from GOPM regarding this account referenced the incorrect statute. In this particular situation, the KRS provided by GOPM had different investment requirements than the requirements of the actual KRS governing the account in question. If OFM had invested these funds in accordance with GOPM guidance, over \$60,000,000 would not have been invested within the intentions of the law. Given the above, this finding is reportable control weakness.
- 4) Although we understand GOPM's position, we again recommend that when a SAS-14 form is prepared, the agencies involved should be required to sign the form acknowledging they are aware of the account changes. An example of the importance of this is 1400-540-XX-XXX-DDGC, which is a cash account within the Kentucky School for the Blind. Apparently, this account held bequests received over a number of years and earnings posted to this account and were used for the benefit of Kentucky School for the Blind students. At some point, however, the post-to-account was changed to the Capital Construction Fund and interest has posted there for a number of years since then until the APA identified this matter.

**FINDING 05-FAC-06: The Office Of Financial Management Should Develop
Procedures To Review Statutory References**

During the audit of the State Investment Pool, we confirmed that the Office of Financial Management (OFM) does not review the statutory references on SAS-14 forms provided by the Governor's Office for Policy and Management (GOPM). These forms detail the statutory reference(s) governing cash accounts, which can include information on limitations on how the money should be invested.

The internal control weakness noted above was caused by OFM's belief that GOPM has responsibility to research the statutes referenced in the SAS-14 forms and proactively inform OFM of any specific investment requirements. Without adequate review of the statutes and the completed SAS-14 forms, funds may not be invested, as intended by the law and the investment income would not be credited to the proper accounts.

Good internal controls dictate that agencies develop procedures to ensure compliance with laws governing the investing of state funds.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-06: The Office Of Financial Management Should Develop
Procedures To Review Statutory References (Continued)****Recommendation**

We recommend that OFM's accountants review the statutory references in all SAS-14 forms received from GOPM and inform the investment traders of any specific requirements contained in the statutes.

Management's Response and Corrective Action Plan

The Office of Financial Management respectfully disagrees with this recommendation. As noted in a letter dated February 7, 2006 from John T. Hicks, Deputy Director of the Governor's Office for Policy and Management, it is the responsibility of the Office of the State Budget Director to approve the accrual of interest income and to document the appropriate statute, regulation, federal law or rule, or other authority.

Auditor's Reply

The APA and OFM agree on the responsibility of the Office of the State Budget Director to approve the accrual of investment income and to document the appropriate statute, regulation, federal law, or other authority on the SAS-14 forms. It is the responsibility of OFM, however, to look up the reference provided on the SAS-14 form, note the investment restrictions or guidance, and to make investment decisions based upon the guidance provided in the statute, authority, etc.

**FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure
Procurements Are Made In Accordance With Finance And Administration Cabinet
Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly**

As a part of the FY 2005 Comprehensive Annual Financial Report (CAFR) audit, we selected a small sample of contracts and tested the procurement process for compliance with the Finance and Administration Cabinet's policies and procedures. During this testing, we noted the following noncompliances:

1. In four of the four contracts examined, FAC did not maintain documentation evidencing that FAC or the procuring agency verified that the winning vendors had not been debarred from doing business with the federal government (4 of 4, or 100%). FAC relied upon the certifications made by the vendors in their RFP submissions. In one instance where the website was apparently checked, documentation was likely not kept because the vendor was not listed as being debarred. The effect of not checking to

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)

ensure vendors are not debarred is detailed in item #2 below. The effect of not maintaining evidence of this verification is that procuring agencies cannot demonstrate their compliance with this FAP requirement to outside third parties. Section 1 of FAP 111-59-00 Federal Debarment states:

Prior to contract award, an agency initiating a procurement of \$100,000 or more, any amount of which is federally funded, shall ensure that the successful vendor is not debarred from doing business with federal agencies. An agency may access the List of Parties Excluded from Federal Procurement and Non-procurement Programs on the U. S. General Services Administration (GSA) website to verify that the vendor is not debarred.

2. Based upon discussions with agency personnel, in three of the four contracts examined, no attempt had been made to confirm that winning vendors were not debarred from doing business with the federal government. Failing to ensure vendors are not debarred from doing business with the federal government likely results from a misunderstanding of the FAP 111-59-00 requirements. It would seem that procuring agencies are relying upon the vendor certifications detailed in Sections 2 and 3 of FAP 111-59-00 as a substitute for the Section 1 requirement. This section requires the Commonwealth to verify the listing of debarred entities maintained at <http://www.elps.gov>. Failure to verify this information may result in questioned costs if a contract is awarded to a debarred vendor. Depending upon the size of the contract, this could result in a considerable loss to the Commonwealth. Fortunately, none of these vendors were debarred.

3. In one instance, FAC did not obtain the required vendor certifications as required by Sections 2 or 3 of FAP 111-59-00. Sections 2 and 3 of FAP 111-59-00 provide that:

An agency may include in a solicitation a statement that the vendor's signature on a solicitation response certifies that the vendor is not debarred from doing business with federal agencies and that if debarred during the life of the contract, the vendor will notify the Commonwealth...If a solicitation does not contain the statement established in section 2 of this policy, the vendor shall submit, with its solicitation response, a written certification on the vendor's letterhead that the vendor is not debarred from doing business with federal agencies and that, if debarred during the life of an extended term contract, the vendor will notify the Commonwealth buyer of record within seventy-two (72) hours of the federal debarment.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)**

4. In one instance FAC could not produce all of the required EEO forms/reports. Either the required EEO forms were not obtained from the vendor or they were subsequently misplaced. If the forms were not obtained from the vendor, section 11 of FAP 111-10-00 states that, "Failure to comply with any provisions of KRS 45.550 to 45.640 shall constitute a material breach of contract." If the forms were obtained but have since been misplaced, FAC no longer has the ability to provide assurance that this vendor was compliant with the EEO requirements. Section 10 – Reporting Compliance or Breach of FAP 110-10-00 *General Conditions and Instructions for Solicitations and Contracts* states the following:

Upon being declared the successful bidder, the contractor or vendor shall complete an Equal Employment Opportunity (EEO) template designed by the Finance and Administration Cabinet. The EEO form shall provide a breakdown of the bidding party's existing workforce, indicating the race, sex, age, position held, county and state of residence, and date of employment of each employee. A successful bidder shall submit data as required by KRS 45.550 to 45.640 and a statement of intent to comply in full with all requirements of the Kentucky Civil Rights Act.

5. In one instance, FAC could not produce any evidence confirming that the winning vendor's RFP submission had been received prior to the deadline established in the RFP. FAC did not know whether the time/date stamping showing the timely submission of the winning vendor's RFP response was originally kept or if this evidence was misplaced (during subsequent open records requests, etc). Without such evidence, the procuring agency cannot prove to outside third parties (such as potential protestors) that the vendor's response was submitted timely. Section 5(l) – Bid Submission Compliance and Provisions of FAP 110-10-00 *General Conditions and Instructions for Solicitations and Contracts* states that bidders shall "Ensure the bid response is submitted as a formal online bid in the state's procurement system or arrives in the Division of Material and Procurement Services before the time specified in the Solicitation."
6. In three of four contracts examined, FAC did not score the contracts in accordance with the criteria established in the RFP and mathematical errors were made during the scoring process. Two different scoring errors occurred and they will be discussed separately.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)

- a. A review of the Kentucky Medicaid Administrative Agent (KMAA) solicitation (S-04186689) scoring revealed that the technical scoring was not evaluated in accordance with the criteria established in the RFP. The RFP stated that technical scores would be “nominalized” based upon a formula, for the contract noted, FAC did not perform this nominalization process. Failure to score responses in accordance with this section of the RFP resulted in understating the winning vendor’s total score by 305.55 points and understating the losing vendor’s score by 328.75 points. Fortunately, this error did not change the overall outcome of the award. If, however, the scores between the top two vendors had been closer, this could have caused the contract to be awarded to the wrong vendor, which could have been both expensive and embarrassing for the Commonwealth.
- b. A review of the Medicaid Management Information System (KY MMIS) solicitation (S-04048404) scoring revealed that there was a math error in the scoring of the oral presentation. According to the evaluation worksheet we reviewed, each evaluator’s scores for the losing vendor were as follows: 1) 300, 2) 350, 3) 300, 4) 300, 5) 300 and the “consensus/average score” was listed as 350. The average of these scores, however, is actually 310, which appears to have overstated the losing vendor’s scores by 40 points. In addition, a review of the Energy Savings Performance solicitation (S-03405172) scoring process revealed a math error on the winning vendor’s score sheet, which resulted in an understatement of their score by 25 points. Fortunately, in both cases, these math errors did not change the overall outcome of the award. However, if scores between the top two vendors were closer, this could have caused the contract to be awarded to the incorrect vendor, which could have been both expensive and embarrassing for the Commonwealth.

Section 4 - Best Value Procurement of FAP 111-35-00 *Competitive Sealed Bidding* states, “In accordance with KRS 45A.080, contracts issued in response to competitive sealed bids shall be awarded on the basis of best value criteria, as defined in KRS 45A.070(3).” In addition, good internal controls dictate that when awards are based upon a mathematical scoring process, the data and formulas should be rechecked (preferably by a different person) for accuracy prior to the award of the contract.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)**

Recommendation

We recommend the following:

1. In accordance with FAP 111-59-00, we recommend that FAC (and not the procuring agency since they may not be aware of all of the procurement requirements) be delegated the responsibility to verify that vendors are not debarred from doing business with the federal government. This assurance can be obtained by accessing the Excluded Parties List System, which is maintained at <http://www.epls.gov>. A screen print showing that the vendor was not debarred should be included with the file evidencing this procedure.
2. See item number one above. In addition, the non-procurement debarment and suspension common rules were revised by the federal government. These revised rules were published in the November 26, 2003 Federal Register (68FR66583-66632) and the updated rules reduced the threshold for covered procurement transactions from \$100,000 to \$25,000. We recommend FAC update FAP 111-59-00 to comply with this threshold reduction.
3. FAC ensure that all contracts have the certification required by Section 2 of FAP 111-59-00.
4. FAC verify that all applicable EEO forms have been requested and received from winning vendors and that these forms be maintained.
5. FAC and/or procuring agencies time/date stamp all bid submission and maintain this documentation for the required length of time as designated by the Kentucky Library and Archives Retention Schedule.
6. Scoring should be performed in accordance with the criteria established in the RFP. Since scoring problems were noted with 3 of the 4 contracts reviewed (or 75%), all scoring should be reviewed and recalculated by a second party to ensure mathematical accuracy and adherence to scoring criteria found in the RFP. Evidence of this review and recalculation should be documented in the file.

Management's Response and Corrective Action Plan**Office of Materials and Procurement Services (Item 1, 2, 6):**

OMPS management is aware of two (2) contracts that were issued by OMPS that were included in the test. Those include contracts issued from S-04196689 KMAA and S-04048404 MMIS. Management's response is limited to these contracts and the conditions (Item 1,2,6) mentioned above.

FINANCIAL STATEMENT FINDINGS

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FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)

Management's Response and Corrective Action Plan (Continued)

(1) Management disagrees that Condition 1 is in noncompliance of FAP-111-59-00. Although the FAP requires ensuring potential vendors are not debarred or suspended, it does not require the referenced documentation.

(2) Both solicitations required a statement from the bidder regarding (Section 50.180) Certifications Regarding Debarment and Suspension and awarded bidders Certified they were not Debarred or Suspended in required Transmittal Letters. Finance and Administration Cabinet, OMPS will perform and document verification for debarred or suspended vendors for contracts awarded by the OMPS. OMPS will instruct agencies awarding contracts that the verification of Debarment and Suspended status must be completed before finalizing award of contract.

(6) Management concurs that scoring should be performed in accordance with the criteria established in the RFP and math errors may occur. Management will take appropriate action to ensure correct mathematical calculations of RFP scoring. However, management would like to explain the evaluation process of the MMIS RFP. The Commonwealth evaluates a proposal by assigning scores in the categories according to the established criteria of the RFP. Scoring is based upon consensus or group scoring methodology. Consensus scoring methodology does not mean calculating an average score, but is defined as reaching a score that the entire evaluation team agrees on. For this reason, the evaluators' individual scores are not made public record. The only scores that are relevant and are made public record are the consensus scores. The consensus score in this case was 350. Therefore, based on the method in which OMPS conducted its evaluation, a mathematical error was not made.

Note: Finance is not aware of any compliance issues with federal requirements as conducted by Federal Audits of agencies for debarment or suspended vendors.

Division of Engineering and Contract Administration (Item 1, 2, 3, 5, 6):

1 - The following corrective action was taken in response to "Condition (Nature of the Noncompliance)" number one:

All buyers have been instructed to access <http://www.elps.gov> to verify that vendors have not been federally debarred prior to award of contract. In addition, direction has been given to maintain documentation that this check has been performed in the file.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)**

Management's Response and Corrective Action Plan (Continued)

2 - see number one above

3 - The following corrective action was taken on November 16, 2005 to address the issues raised in your "Condition (Nature of the Noncompliance)": number 3.

Effective immediately, please add the following statement to the Authentication of Bid page (FP-3) in each RFB. The "Merge Forms P2's" have been modified, but please make sure you modify your template, wherever you keep it stored. This will eliminate having to insert it into only those projects which utilize any federal funding and are over \$100,000. If this statement is not included in the RFB, the vendor is required to certify on their letterhead, with their bid response, that they are not debarred. If you currently have bids out that utilize federal funds, either do a modification to include this language, or ensure that the vendor provides the required statement with their response.

I hereby certify:

That the bidder is not debarred from doing business with federal agencies and that, if debarred during the life of the contract, the bidder will notify the Commonwealth buyer of record within seventy-two (72) hours of the federal debarment. Subsequent to this original notice being sent out, another communication was sent out to change the dollar amount over which this certification is required to \$25,000

5 - It is currently our policy to date stamp all submittals. We concur with your recommendation and will reiterate that to all staff.

6 - We concur with your recommendation to document a second check of all RFP scoring calculations and have added an "initial line" to our RFP meeting checklist to ensure that this second check is performed and documented.

Office of EEO and Contract Compliance (Item 4):

The Finance and Administration Cabinet agrees with the recommendation. Effective November 2004, the Office of EEO and Contract Compliance (EEO/CC) implemented a revised review procedure that affected all contracts subject to KRS submitted for review before initial contract award. Upon receipt of required 45.560 – KRS 45.640. According to the procedure, each of the four EEO forms—employment utilization (EEO-1 or EEO/CC-257), affidavit of intent to comply,

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-07: The Finance And Administration Cabinet Should Ensure Procurements Are Made In Accordance With Finance And Administration Cabinet Policies And Procedures And Ensure That Vendor Submissions Are Scored Correctly (Continued)

Management's Response and Corrective Action Plan (Continued)

subcontractor report form and employee data sheet—must be completed, signed and documentation, EEO/CC conducts a desk audit review to determine whether the company is eligible for certification.

Subsequent to the procedural change, EEO/CC advised buyers either verbally or via e-mail. Later, EEO/CC met with the contracting agencies to discuss the revised procedures. To further enhance compliance efforts, EEO/CC also implemented a comprehensive file audit (September 2005) and mail log system (July 2005) to

- Ensure proper file set-up (document chronology, notes regarding telephone conversations, etc.)*
- Determine active or complete status*
- Archive documents according to the state documentation retention schedule*
- Verify current certification status*
- Confirm receipt of documents received via regular mail, messenger mail, facsimile, and package delivery service*

Effective March 2006, EEO/CC will begin reviewing active contracts with a pre-November 2004 approval date to ensure required EEO forms are on file.

FINDING 05-FAC-08: The Finance And Administration Cabinet Should Review And Document Potential Conflicts Of Interest Prior To Awarding Contracts

As part of our FY 2005 CAFR audit, we tested four (4) contracts for compliance with FAC policies and procedures. While reviewing the Kentucky Medicaid Administrative Agent (KMAA) solicitation (S-04186689) evaluation process, we noted that the Kentucky Health Partners, LLC submission was disqualified from the RFP evaluation process. The Determination and Findings for this RFP stated the following:

Kentucky Health Partners, LLC submitted a response to the Solicitation, in which documentation from the primary subcontractor shows that the subcontractor has retained the former Commissioner of DMS to assist in recruiting staff to comply with staffing requirements of this Solicitation and potential contract award. It is our understanding that the former Commissioner was employed by DMS through October 2004. Furthermore,

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-08: The Finance And Administration Cabinet Should Review And Document Potential Conflicts Of Interest Prior To Awarding Contracts (Continued)**

as part of his responsibilities as Commissioner, he would have been considered directly involved in all matters relating to DMS. This would include the discussion and development of this Solicitation and any confidential discussions on this matter, prior to his termination of employment by DMS, to which other vendors who responded to this Solicitation would not have had equal and fair access. Unfortunately, this prior relationship raises the strong appearance of an impropriety, which cannot be ignored. Allowing this vendor to continue to participate in this particular procurement would violate KRS 45A.010 and reduce public confidence in an impartial procurement process being conducted for a Medicaid Administrative Agent contract. Therefore, based upon this conflict of interest, their response was disqualified from any further consideration.

A review of the First Health Services (FHS) RFP submission (the winning vendor) reveals that they also retained a former employee of the Department of Medicaid Services (DMS). A former Division Director of Medicaid was selected to be the Member Services Manager, which is listed as one of the key positions in their RFP. Since the Kentucky Health Partners, LLC (KHP) submission was disqualified from consideration as a result of a conflict of interest we had the following concerns:

- Since the KHP RFP was disqualified as a result of the former Commissioner being employed, was the former Division Director's employment with DMS considered by Finance as well? If so, was this consideration documented?
- It would appear that Finance handled the bid protests for this procurement in an inconsistent manner since the KHP bid was disqualified because of the employment of the former Medicaid Commissioner. In the protest filed by another bidder regarding the FHS' employment of former DMS employees, although no specific employees were identified, Finance did not disqualify the FHS RFP and we found no documentation of how this determination was reached.
- While the former Commissioner was apparently terminated in October 2004, it seems that the former Division Director retired around July 30, 2004. Based upon the information maintained in Procurement Desktop, a draft of this RFP was at least in place prior to May 20th, 2004. Was the former Division Director involved in the preparation or discussions of this RFP? If so, how involved was she in these discussions? Even if they weren't involved, as a former Division Director at DMS, would they have had access to information on this RFP that other vendors would not have had equal and fair access to?

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-08: The Finance And Administration Cabinet Should Review And Document Potential Conflicts Of Interest Prior To Awarding Contracts (Continued)

- A review of the Division Director's resume in the submission indicated that, the Division Director was "Responsible for RFI, RFP preparation and review/evaluation." Did she have any involvement with this RFP? Again, if not, would she have had access to any information on this RFP that other vendors would not have had access to?

Although the extent of the Division Director's involvement with the KMAA RFP is unknown, when we asked agency personnel about their consideration of her prior employment with DMS, we were informed that, "there were discussions about the Division Director, as well as others, during the evaluation of proposals. The agency purchaser does not remember specifics about the discussions other than that the former Division Director was not employed by the Commonwealth at the time the RFP was released in October 2004, that the RFP had undergone significant revisions after the employee's retirement, it was believed that she had not accepted employment from any offeror submitting a proposal as she had submitted a letter of intent to be employed by at least two of the offerors."

Given the facts and circumstances with the information available, it would appear that the Division Director's situation potentially could also have been a conflict of interest. During our review, however, we were unable to locate written documentation or a formal determination indicating an absence of a conflict of interest. The former Division Director might have been in a position to have access to information that other vendors may not have had equal and fair access to. If this is the case, it is possible the First Health Services RFP submission should have been disqualified as well.

Section 2(e) of KRS 45A.010 states, "The underlying purposes and policies of this code shall be to ensure the fair and equitable treatment of all persons who deal with the procurement system of the Commonwealth."

Recommendation

We recommend that Finance review all RFP submissions for potential conflicts of interests prior to awarding contracts. Should a potentially controversial issue be discovered, the review process, questions asked, responses received, discussions and conclusions should be documented in enough detail so that an independent reviewer would arrive at the same conclusion as Finance.

In addition, we recommend that Finance require potential contractors to submit a statement with their bid proposal that identifies any former state employees that were hired (or will be hired) within six (6) months of the RFP submission or award date. This list should include the former state employee's name, former agency or cabinet, and the date of termination from state employment.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-08: The Finance And Administration Cabinet Should Review And Document Potential Conflicts Of Interest Prior To Awarding Contracts (Continued)****Recommendation**

We also recommend that the Secretary of Finance review this RFP to determine if this situation constituted a conflict of interest. In addition, the Secretary should investigate to see if First Health Services employed other former employees of DMS and determine if their employment also represents a conflict of interest.

A copy of this finding will be submitted to the Ethics Commission for their review and determinations.

Management's Response and Corrective Action Plan

Management concurs that determinations on issues should be sufficiently documented.

The Finance and Administration Cabinet will work with the Executive Branch Ethics Commission to identify potential ethic violations.

The Finance and Administration Cabinet will work with the Cabinet for Health and Family Services to determine if the KMAA situation constitutes a conflict of interest and will assist the Executive Branch Ethics Commission should they determine that this situation warrants an investigation.

FINDING 05-FAC-09: The Finance And Administration Cabinet Should Develop Procedures To Ensure All Supporting Documentation Is Retained

During our testing of capital project expenditures, we noted three (3) wire transfer documents of the 37 transactions tested could not be located. These expenditures totaling \$7,073,440.42 were payment for capital projects materials and services to the University of Kentucky and the University of Louisville.

Agency personnel indicated that the office that had possession of the documents had moved and that they could no longer find the information.

Failure to maintain documentation precludes auditors or any other independent reviewer of expenditures of the ability to determine the propriety and adequacy of expending state moneys. Good internal control and the state retention schedule require that documentation be maintained. The Kentucky Department for Library and Archives, as authorized by KRS 171.420, establishes a record retention schedule for all state agencies. This schedule as found on page F-2, series # F0010 requires that capital project payment documents be

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-FAC-09: The Finance And Administration Cabinet Should Develop Procedures To Ensure All Supporting Documentation Is Retained (Continued)

maintained at the agency for at least eight years. In addition, since capital projects may exceed multiple fiscal years, the need to maintain an adequate filing and retention process becomes even more important.

Recommendation

We recommend FAC implement procedures to ensure all documents are retained for the required period of time, as required by the Kentucky Department for Library and Archives retention schedule.

Management's Response and Corrective Action Plan

The three documents in question were all from early December 2004, a time when there was movement of offices within the Controller's Office. These documents were placed in a tray waiting to be filed when moving time came unexpectedly. The tray was moved to the Controller's conference room, where it stayed for about ten months. When more moves became imminent, the conference room was cleaned out, and it appears these documents disappeared. Since the first move in December 2004, a FAC employee has been filing the documents as he approves them. They are now filed in a central location.

FINDING 05-FAC-10: The Finance And Administration Cabinet Should Permanently Remove The University Of Louisville Land Contract Journal Voucher Recorded Annually For CAFR Compilation

During the Investment Audit, we noted a journal voucher to the MARS accounting system, which increased the cash in Fund 0200 by \$11,847,534.48 and removed land with a historical cost of the same amount. The FAC CAFR Compilation Manual states that when the University of Louisville Hospital was constructed, both the City of Louisville and Jefferson County refused to pay a portion of the cost, which was subsequently paid by the Commonwealth. Later, the city and county deeded a piece of land to the Commonwealth for repayment of this debt. This land, however, subsequently became the Commonwealth's contribution to the construction of the Papa John's stadium in Louisville.

A review of the historical JV's and the information related to this transaction indicated that the Commonwealth no longer has title to the land; therefore removing it from the MARS accounting system seems appropriate. This review also indicated that the Commonwealth does not have the \$11,847,534.48 of cash recorded on the JV. In essence, recording this journal voucher each year causes the Commonwealth's financials to not reflect any of these historical transactions since fund balance was never impacted (or any impact on fund balance was later reversed).

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-FAC-10: The Finance And Administration Cabinet Should
Permanently Remove The University Of Louisville Land Contract Journal Voucher
Recorded Annually For CAFR Compilation (Continued)**

This JV is recorded each year during the CAFR compilation process because it is reversed annually after the CAFR is released. The JV that adjusts the CAFR balances seems to represent an asset (cash) that the Commonwealth does not have.

Paragraphs 25 and 26 of Statements of Financial Accounting Concepts (SFAC) 6 provide that “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.”

Recommendation

We recommend FAC take immediate action to permanently remove this transaction from the Commonwealth’s books.

Management’s Response and Corrective Action Plan

A review of historical data reveals that the original receivable in the Capital Projects Fund was written off for CAFR purposes in the FY84 financial report. The receivable remained in the accounting system until FY94, at which time the Commonwealth received a parcel of land from Louisville and Jefferson County governments as a payment in kind. At that time the project account was closed out. The land was entered in the accounting system as an asset (debit) and an offsetting entry was a credit to cash. This entry is reversed out each year since the receivable was written off in FY 84. Fund balance is then correct for financial reporting purposes. This is strictly an accounting system issue and has not resulted in an overstatement of the Financial Statements of the Capital Projects Fund in the CAFR.

Finance agrees with the auditor’s recommendation and will continue to work with the Governor’s Office of Policy and Management (GOPM) to get this transaction permanently removed from the Commonwealth’s accounting system.

FINANCIAL STATEMENT FINDINGS***Material Reportable Conditions Relating to Internal Controls and/or
Material Reportable Instances of Noncompliance*****FINDING 05-FAC-11: The Office Of Financial Management Should Adhere To
Generally Accepted Accounting Principles**

During the audit of the State Investment Pool, we noted the following:

- The Office of Financial Management (OFM) failed to recognize and communicate to Statewide Accounting that \$593,372,259 of TRAN Pool investments, which had trade dates prior to June 30, would be required to be reported in Kentucky's Comprehensive Annual Financial Report.
- The Office of Financial Management (OFM) incorrectly classified \$291,829,711.36 in investments as short-term rather than long-term in the confirmation file statewide accounting uses to record and report investments and related activity in Kentucky's Comprehensive Annual Financial Report.

Upon notification of these errors, FAC and the OFM corrected these items with a JV and a revised confirmation database.

The errors above were caused by the following:

- OFM's accounting staff's lack of understanding of Generally Accepted Accounting Principles (GAAP) established by the Governmental Account Standards Board (GASB) as it relates to the accounting and the reporting of investments and related activity.
- An inadequate review by OFM's accounting staff of files and other correspondence created for statewide accounting by OFM's investment traders.

If these errors had not been detected, the general fund's assets and liabilities would have been materially misstated in the FY 2005 CAFR.

GASB Comprehensive Implementation Guide-2004 Questions and Answers, Chapter 6, Question 64 states "Investment transactions should be accounted for based on the trade date. The trade date is the date on which the transaction occurred and is the date the government is exposed to (or released from) the rights and obligations of the ownership of the instrument."

Accountants providing information for financial reporting purposes should have an understanding of GAAP and should have a review process sufficient to prevent significant errors or omissions.

FINANCIAL STATEMENT FINDINGS

Material Reportable Conditions Relating to Internal Controls and/or Material Reportable Instances of Noncompliance

FINDING 05-FAC-11: The Office Of Financial Management Should Adhere To Generally Accepted Accounting Principles (Continued)

Recommendation

We recommend OFM's accountants implement the following:

- Receive training and/or obtain current GASB guidance and become familiar with investment-related GAAP.
- Review all investment reporting information prepared by the investment traders for completeness and conformity with GAAP.

Management's Response and Corrective Action Plan

The Office of Financial Management respectfully disagrees with the recommendations noted above. The office consulted with Statewide Accounting Service and was advised to report investment transactions on a settlement date basis and not trade date since MARS does not recognize trade date accounting. The referenced transactions regarding the TRAN Pool were accounted for as previously advised. OFM understands that with respect to the TRAN assets and liabilities that Statewide Accounting has since reflected this in the balance sheet.

OFM will continue to consult with Statewide Accounting Service concerning the GAAP / GASB reporting requirements.

The second item is simply a classification issue based upon a misunderstanding of the initial request and has no bearing on the securities or the pools where they are held.

Auditor's Reply

Although Statewide Accounting Service may have advised to report investment transactions using the settlement date and not the trade date, since the Office of Financial Management's accounting section is responsible for recording and reporting investment information in MARS, they should have been aware that GAAP requires that transactions be recorded and reported using the trade date. We reaffirm the recommendation that OFM's staff receive appropriate training and/or obtain current GASB guidance to comply with investment-related GAAP to prevent future material financial statement misstatements.

While OFM may be correct that the misclassification of short-term investments as long-term investments did not have any bearing on the securities, pools, or where they are held, the misclassification would have distorted the appearance of the liquidity of the Commonwealth's investments by causing almost \$292 million of investments to be reported incorrectly as short-term investments. Therefore, by having the accounting section review this information prior to submitting to Statewide Accounting, this will hopefully prevent such errors in the future

FINANCIAL STATEMENT FINDINGS

Material Reportable Conditions Relating to Internal Controls and/or Material Reportable Instances of Noncompliance

FINDING 05-FAC-12: The Finance And Administration Cabinet Should Develop Procedures To Ensure Proper Classification And Completeness Of The CAFR Cash And Investment Note

The Finance and Administration Cabinet (FAC) Comprehensive Annual Financial Reporting (CAFR) Team prepared the note disclosure entitled Cash and Investments (Note 5). The CAFR team uses confirmations, AFR forms, and independent audit reports to compile summary sheets for each of the Commonwealth's component units for the disclosure. The summary sheets for each entity provide cash and investment classifications and other information necessary for compiling Note 5 disclosure in accordance with the GASB 40 requirements. In reviewing supporting information for each summary sheet, we noted the following problems:

- Cash and Investments were not properly classified by investment type
- Some investment information was excluded from the interest rate risk tables
- Problems occurred with overall compilation of entity information into the final Note 5 tables

Classification of Cash and Investment Information in the Note 5 Disclosure

As noted in each prior year audit report since FY 2001, FAC has had classification problems concerning investments. This year, each of the ten summary sheets examined had cash or investments incorrectly classified in at least one of the Note 5 disclosure tables. For example, \$56,339,143 of the University of Kentucky's common and preferred stock was originally classified as commercial paper in the Investments and Credit Ratings table. Paragraph 4 of GASB 40 – *Deposit and Investment Risk Disclosures* states, "Unless otherwise required, investment disclosures should be organized by investment type, such as U.S. Treasuries, corporate bonds, or commercial paper. Dissimilar investments, such as U.S. Treasury bills and U.S. Treasury strips, should not be aggregated into a single investment type."

Omission of Cash and Investment Information from the Note 5 Disclosure

While reviewing the summary sheets for each entity, we also noted that some of the cash and investments were not included in the Cash and Investments by Type (Interest Rate Risk) Table. For example, \$3,067,070,000 of the Kentucky Employee Retirement System's Securities Lending investments and \$7,998,201,686 of the Kentucky Employee Teacher Retirement System's investments were excluded. Statement of Financial Accounting Concepts (SFAC) #2 – *Qualitative Characteristics of Accounting Information* states that financial statement information must be both reliable and relevant for users. Paragraph 79 of SFAC 2 provides that, "Reliability implies completeness of information, at least within the bounds of what is material and feasible, considering the cost." Paragraph 80 of SFAC 2 also states that completeness impacts the relevance of information.

FINANCIAL STATEMENT FINDINGS***Material Reportable Conditions Relating to Internal Controls and/or
Material Reportable Instances of Noncompliance*****FINDING 05-FAC-12: The Finance And Administration Cabinet Should Develop
Procedures To Ensure Proper Classification And Completeness Of The CAFR Cash
And Investment Note (Continued)**

Compilation of Cash and Investment Information for the Note 5 Disclosure

We noted several discrepancies during our comparison of the cash and investments reported in the summary sheets and the Note 5 disclosure tables. For example, 1) the omission of \$1,055,790,840 of securities lending investments and \$1,287,800,000 of KTRS' repurchase agreements from table 1, 2) The exclusion of \$189,294,988 of KTRS' U.S. Treasury securities and \$732,378,811 of securities lending investments from table 3, and 3) \$1,223,268,858 of KTRS' U.S. Agencies counted twice in table 4.

These incorrect classifications, omissions, and compilation errors likely resulted from an oversight or cell formula errors within the Microsoft Excel worksheets used for the overall compilation of Note 5. These errors, if undetected, would have distorted the presentation of the Commonwealth's liquidity, risk, and investment holdings to potential users of the financial statements.

Part of an effective internal control system includes ensuring the reliability of financial statements. Since the Note 5 tables are compiled using Microsoft Excel formulas, good internal controls dictate that these cell formulas be set up properly to ensure the financial statements and related disclosures accurately summarize the supporting data.

Recommendation

Although the CAFR reporting team did a good job with the implementation of GASB 40 this year, we recommend Finance consider the following for future Note 5 CAFR disclosures:

Classification of Cash and Investment Information in the Note 5 Disclosure

When compiling information for Note 5, we recommend that Finance consider all available information (CPA audited financial statements, note disclosures, AFR forms, etc.) and ensure that investments are classified correctly by investment type.

Omission of Cash and Investment Information from the Note 5 Disclosure

Prior to compiling cash and investment information, Finance should determine what or how much investment information should be reported in each table. In addition, tables containing all cash and/or investments should be reconciled with the cash and/or investments presented in the statement of net assets to ensure that the disclosure is complete

FINANCIAL STATEMENT FINDINGS***Material Reportable Conditions Relating to Internal Controls and/or
Material Reportable Instances of Noncompliance*****FINDING 05-FAC-12: The Finance And Administration Cabinet Should Develop
Procedures To Ensure Proper Classification And Completeness Of The CAFR Cash
And Investment Note (Continued)**

Recommendation**Compilation of Cash and Investment Information for the Note 5 Disclosure**

Although we recognize that the compilation process and linking of the worksheets in Microsoft Excel is a difficult process, Finance should ensure that cell formulas are set up properly to ensure that the information disclosed accurately represents the information compiled in each entity's summary sheet. One-way to provide assurance the formulas are accurate would be to have someone manually recalculate the table disclosures for accuracy and completeness.

Management's Response and Corrective Action Plan

The financial reporting team will review the manner in which information is gathered from components units and the manner in which it is compiled into the notes to assure that all information is included in the correct categories. Information will be reviewed to determine that it is complete and agrees with audited financial statements.

For FY 2005, we were in the process of implementing a new governmental accounting standard (GASB 40), and the preliminary note disclosure given to the auditor was incomplete. This information was furnished with the belief that this was the starting point for the audit and the auditor would expect changes, since not all of the information had been received from the component units and we were still finalizing the classifications and amounts. In the future we will be sure the information is complete before being released for review

Auditor's Reply

During the audit, we understood that the note disclosure was incomplete and was only a starting point. The problems with the note, however, did not relate to the implementation of GASB 40 but related to the continuing problem of misclassifying investments/investment types. Likewise, the cell formula errors used in the compilation of the note also did not relate to the implementation of GASB 40. Given this, we reaffirm the recommendations noted above.

FINANCIAL STATEMENT FINDINGS

Material Reportable Conditions Relating to Internal Controls and/or Material Reportable Instances of Noncompliance

FINDING 05-FAC-13: The Finance And Administration Cabinet Should Improve Audit Documentation Over The Recording Of Year-End Accruals

The Finance and Administration Cabinet (FAC) reporting team prepares year-end accruals from the AFR forms received from state agencies. During our audit of the year-end accruals, several errors were noted which, if not detected, would have materially misstated several funds.

Unemployment Insurance Fund Payables

During our review of the AFR forms submitted by agency for FY 2004, we noted that an accounts payable accrual was made for agency 538 (Department for Employment Services) for \$11,937,245 in the Unemployment Insurance Fund (6200). As a result of the recent reorganization, their activity was reported with agency 531 this year; however, no accrual was made at year-end in Fund 6200 for this agency. Apparently, agency 531 submitted an AFR-70, however the former agency 538 was overlooked during the accrual process. After notification from us, the reporting team found the form and accrued the items appropriately. If this error had not been detected, both expenditures and payables would have been understated by \$14,599,229, which is material for Fund 6200.

Capital Projects Fund Payables

Generally, year-end accruals are recorded from AFR forms submitted by state agencies. However, the majority of Capital Projects Fund (Fund 0200) year-end payables (96% this year and 72.7% last year) were recorded based upon expenditures for the FAC's Division of Facilities. This report showed the expenditures made during July 2005, the first month of the fiscal year. Our review of these expenditures revealed a \$12,000,000 payment made for capital construction on a government facility that was not scheduled to begin until the summer of 2006. FAC incorrectly recorded this material amount as an accounts payable. Upon notification from our office, FAC removed the amount as a year-end accrual. We believe there were two reasons that potentially caused this error: 1) the year-end accrual process for Fund 0200 is different than the procedures followed for all other funds and 2) Finance did not review the \$12,000,000 expenditure to determine the necessity or reasonableness of the year-end accrual. If APA personnel had not reviewed these payments, Fund 0200 expenditures and payables would have been overstated by \$12,000,000, which is material for Fund 0200.

Federal and Transportation Fund Year-End Accruals

The year-end receivable accrual utilized a process similar to the payable accrual, AFR forms were received from agencies and the accrual was made based upon the information received from state agencies. Through analytical procedures, we noticed accounts receivable balances in agencies 625 and 630 for FY 2004 Fund 1100 was \$45,282,781 and

FINANCIAL STATEMENT FINDINGS

Material Reportable Conditions Relating to Internal Controls and/or Material Reportable Instances of Noncompliance

FINDING 05-FAC-13: The Finance And Administration Cabinet Should Improve Audit Documentation Over The Recording Of Year-End Accruals (Continued)

\$21,628,265 for agency 625 in Fund 1200, yet were zero for FY 2005. An accounts receivable accrual was not made for either fund or either agency for FY 2005. Upon inquiry from our office, FAC found that the Transportation Cabinet had not submitted an AFR-32 for Funds 1100 and Fund 1200. As a result, adjusting entries of \$21,628,265 and \$46,687,108 were made to Fund 1100 and Fund 1200, respectively. If we had not made inquiries into these variances, it is very likely these adjustments would not have been made. Omitting these accruals would have materially understated Fund 1100 receivables and revenues by \$21,628,265 and caused a significant understatement of Fund 1200 receivables and revenues/deferred revenues by \$46,687,108.

FAC Management should have developed and implemented internal controls over financial reporting to provide reasonable assurance that the financial statements fairly represent the transactions and events that occurred relating to year-end accruals.

Recommendation

We recommend that Finance maintain a tracking log or perform analytical procedures that compare agency accruals by fund and year to ensure the amounts recorded are reasonable. With this comparison, material misstatements such as those noted might be more easily detected. In addition, this review would provide greater assurance that the year-end accruals are accurate, complete, and fairly stated.

Finance personnel have explained their rationale for the procedures followed when accruing the Fund 0200 payables. Should Finance determine that these procedures are adequate for future accruals, we recommend that they review the significant accrued expenditures to ensure that they are accurate, reasonable, and complete prior to recording the adjustment to prevent future material misstatements.

Management's Response and Corrective Action Plan

The Financial Reporting Team is reviewing and revising our procedures to assure that all accruals are appropriately made.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-14: The Office Of Financial Management Should Improve Controls Over The Receipt Of Investment Income**

While testing internal controls over the receipt and recording of investment income, we noted two transactions where all of the proceeds due the Office of Financial Management (OFM) were not collected, as detailed below:

- An investment had a partial call effective September 30, 2004 and a full call effective October 8, 2004. A review of the activity revealed that OFM did not receive the proceeds of the partial call until the date of the full call.
- The selling price and proceeds received on an investment sold on May 23, 2005 for \$100 million, as reported on the broker confirmation did not agree with the selling price and proceeds due on the investor's trade ticket.

OFM personnel were unaware of these exceptions until notified by us.

Circumstances beyond the control of OFM likely caused the partial call proceeds of \$6,763,814.82 (\$6,666,666.67 of principal and \$97,148.15 of interest) to be received eight days late. However, inadequate monitoring of the investment activity and investment terms by OFM personnel caused the Commonwealth to fail to collect interest due on the late payment. If the proceeds due had been received in accordance with the investment terms on September 30th, OFM could have reinvested the proceeds in an overnight investment and could have earned approximately \$2,806.38.

The selling price and proceeds due variance occurred due to an oversight. The selling price per the broker confirmation was 99.97691595 and 99.97656250 per the trade ticket or a variance of 0.00035345. The impact of this variance is insignificant (only \$353.46), however, if the price change had been larger it could have resulted in a much larger loss to the Commonwealth.

The combined effect of the two transactions above resulted in OFM failing to collect \$3,159.84 of income due the Commonwealth. If the sample selected was representative of the entire population of investment income transactions, using extrapolation, the potential loss to investment income would be \$539,319.00.

Good internal controls as well as good stewardship of taxpayer resources dictate that OFM personnel review transactions to ensure that all proceeds due the Commonwealth are collected.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-14: The Office Of Financial Management Should Improve Controls Over The Receipt Of Investment Income (Continued)****Recommendation**

We recommend that OFM personnel:

- Collect the additional proceeds due on the transactions noted above.
- Review FY 2005 and FY 2006 transactions to date to ensure all amounts due the Commonwealth have been collected.
- Develop procedures to examine supporting documentation (such as comparing prices and proceeds due reported on trade tickets and broker confirmations, reviewing security call and settle dates, etc.) to ensure the entire amount due the Commonwealth is collected.

We also recommend that the Accounting Section Supervisor increase the scrutiny and oversight of the accounting function.

Management's Response and Corrective Action Plan

OFM did collect all of the proceeds due. In the first instance a partial early redemption was missed by the then custodian bank, but was collected on the full redemption date, 8 days later. OFM has no control over early redemptions and must rely on the custodian bank under contractual arrangements for this information.

Regarding collecting the interest on the late settlement, the security mentioned was lent out in the securities lending program. We attempted to collect from both parties, but it could not be satisfactorily resolved. Given that we received our full principal, it was determined that the remedy to collect the foregone interest would cost as much or more than the claim.

FINDING 05-FAC-15: The Office Of Financial Management Should Maintain Adequate Documentation To Support Investment Transactions

During our testing of investment income, we noted the following instances where transactions that did not have adequate supporting documentation:

1. The broker confirmation to support the April 22, 2005 sale of \$20,000,000 could not be located. An expanded search of broker confirmations indicated additional missing documentation for numerous FY 2005 purchase and sell transactions. Without broker confirmations, OFM does not have assurance that the proceeds received or payments made were correct.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-15: The Office Of Financial Management Should Maintain Adequate Documentation To Support Investment Transactions (Continued)**

2. OFM did not document their recalculation of fixed coupon due OFM and the variable coupon payable. Nor did OFM document their recalculation of the terms of the transaction (such as interest rates in effect, day counts, etc.). Prior audit reports addressed these issues, yet it appears that our audit recommendations had not been distributed by the accounting supervisor to the appropriate OFM personnel. Given that the notional for the SWAP was \$506,000,000.00, a slight variation in the day count or fixed coupon receivable or variable coupon payable rates could cost the Commonwealth several thousands of dollars daily.
3. We noted one CAMRA revenue adjustment for which no documentation could be provided. OFM explained that the CUSIP was an adjustable rate mortgage and CAMRA could not calculate the correct floating interest rate given the terms of the investment. OFM further explained that the proceeds received were verified against Bloomberg, yet OFM did not maintain documentation of this verification. Failure to adequately document revenue adjustments (such as Bloomberg screen prints, interest recalculations, etc.) does not provide assurance that the adjustment was investigated. This could result in OFM making an adjustment that is not appropriate which would understate or overstate R771 for financial reporting purposes and also cause the Commonwealth to not collect or distribute the revenue it is entitled to receive.

Good internal controls dictate that adequate supporting documentation be requested and retained for investment transactions.

Recommendation

We recommend OFM:

- Request and retain broker confirmations for investment transactions.
- Document their recalculation of SWAP transactions to ensure proper amounts were paid and received. This documentation maintained should include Bloomberg Screen prints, worksheets, day counts, etc.
- Investigate and document revenue adjustments in CAMRA. Documentation of the investigation and conclusions (such as Bloomberg Screen Prints, recalculations, etc.) should be maintained with the revenue adjustment.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-15: The Office Of Financial Management Should Maintain Adequate Documentation To Support Investment Transactions (Continued)****Management's Response and Corrective Action Plan**

1. *The Office of Financial Management (OFM) disagrees with the statement "Without having broker confirmations, the Office of Financial Management does not have assurance that the proceeds received or payments made are correct". If the proceeds received or payments made are not correct, the bonds will not settle. The Accounting Section reconciles on a daily basis to ensure all cash transactions at our custodian were received/paid in a timely and accurate manner. In addition, a monthly reconciliation is performed of all holdings within our portfolio and any discrepancies are researched and resolved.*

Broker confirmations from Merrill Lynch were missing on several trades. The Accounting Department sent a list of missing confirmations to the Investment Department in July 2005. A request was put into Merrill Lynch for copies of the missing confirmations. Merrill did not provide the information until we issued a separate request in January 2006. All missing confirmations from Merrill Lynch have been received.

2. *OFM personnel performed a review and recalculation of the FY05 SWAP transactions with Citigroup and found the terms and amounts to be as agreed in the confirmation. The Accounting Section Supervisor has discussed the importance of maintaining appropriate documentation with staff.*
3. *Revenue adjustments are kept in a CAMRA adjustments file as well as with the reconciliations. Revenue adjustments will have adequate documentation of the investigation and conclusion. This documentation will continue to be maintained within a separate CAMRA file and maintained with the daily reconciliation.*

FINDING 05-FAC-16: The Office Of Financial Management Should Develop Procedures To Review And Approve Revenue Adjustments To Investment Income

During the investment income audit, we requested a report of all investment income that was written off in CAMRA during FY 2005. The report provided details 268 adjustments (adjustments less than \$1 were omitted) that resulted in a \$751,942.44 reduction in investment income. Although these revenue adjustments are prepared by the Program Analyst and are agreed with the amount of investment income received and recorded in MARS by the Financial Analyst, this does not provide any assurance on the necessity or proper recording of the adjustment. In addition, the Program Analyst's revenue adjustments did not go through a formal review and approval process by the Accounting Section Supervisor.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-16: The Office Of Financial Management Should Develop
Procedures To Review And Approve Revenue Adjustments To Investment Income
(Continued)**

Failing to review revenue adjustments results from an inadequate oversight of the accounting and reporting function by the Accounting Section Supervisor. There are several potential adverse effects of these adjustments not having adequate review or approval by the Accounting Section Supervisor, including: 1) understatement or overstatement of R771 for CAFR reporting purposes, 2) state investment pool participants not receiving the investment income that is due them, or 3) increased risk of misappropriation of state assets since CAMRA's projections are adjusted to agree with the deposits recorded in MARS.

Good internal controls dictate that revenue adjustments be reviewed and approved by an appropriate level of management.

Recommendation

Since many of OFM's investments can be very complex, it is necessary that revenue adjustments be evaluated by OFM personnel with sufficient understanding of the investment and the investment terms as well as an understanding of the consequences of revenue adjustments. Accordingly, we recommend that revenue adjustments be investigated thoroughly by OFM staff and then presented to the Accounting Section Supervisor for review and approval. Documentation of these adjustments and the subsequent review and approval should also be kept in the files.

Management's Response and Corrective Action Plan

In October 2005, the Accounting Section Supervisor began reviewing a listing of Interest Adjustments for each month. Beginning with February 2006, the Supervisor will review the supporting documentation for any adjustment exceeding \$1,000 to ensure the adjustment appears proper.

OFM disagrees with the statement that the lack of approval by the Accounting Section Supervisor would increase the risk of misappropriation of state assets. The interest payments and adjustments in CAMRA are reconciled daily to the amount of cash received at the custodian bank. The assets cannot be misappropriated if the proper amounts were received and verified by another staff member.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-17: The Finance And Administration Cabinet Should Improve
Monthly Reconciliation Procedures**

As noted during the previous audit of the Commonwealth's Cash and Investments System, the Office of Financial Management (OFM) did not adequately document reconciliation procedures to show that manual entries made within the program that is used for end of month processing were appropriate and authorized.

Reconciliation procedures are performed after the final run of End of Month processing to ensure the payoffs and adjustments provided by management matches those amounts reported by the program for each pool. We found that documentation was not being consistently maintained with the monthly reconciliation concerning the amounts being entered into the end of month programs for payoffs and adjustments.

Without complete and thorough reconciliation procedures, the risk of unauthorized entries to the SAS programs that perform monthly processing is increased. In addition, if payoff and adjustments amounts are not accurately defined in the monthly processing, certain accounts may not receive an appropriate cash distribution.

Reconciliation procedures should ensure manual entries made in the SAS programs are authorized. Sufficient documentation should be maintained within the reconciliation file to show that the values of manual entries are appropriate.

Due to a change in the timing of the auditor's review of certain IT processes and controls, the testing of FY 2005 IT processes and controls was conducted prior to the agency having an opportunity to remedy the issues identified in the FY 2004 report comments.

Recommendation

We recommend that OFM expand on the monthly reconciliation procedures already in place by retaining documentation to show the initial request for payoffs and adjustments. Further, documentation should be kept explaining any differences between this initial request and the final amounts within the End of Month program. The documentation maintained should support the manual entries made by the programmer within the End of Month SAS programs.

We are aware that OFM is in the process of developing a new system, which may automate the payoff amount determination. We recommend that this function be developed, if feasible.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-17: The Finance And Administration Cabinet Should Improve
Monthly Reconciliation Procedures (Continued)****Management's Response and Corrective Action Plan**

For the remainder of FY 2005, the Accounting/IT Section supervisor will be designating the amount to payoff within each pool by writing the request and signing it. The programmer will then enter the payoff amount. After month end is finalized and reviewed, the supervisor will sign off on the month end reports. Beginning with FY2006, we will have an automatic payoff process. The program will calculate 10% of available cash to distribute and allow that amount to be used to payoff closed accounts prior to final distribution to other accounts. This will cut down on the manual entries that are necessary at the current time.

One primary month end file will be maintained with all of the signed documentation and final reports. Starting with February 2005 the primary month end file will be maintained in the supervisor's office.

**FINDING 05-FAC-18: The Finance And Administration Cabinet Should Ensure The
Statistical Analysis System Manual Is Kept Up-To-Date**

During FY 2004, in response to a prior year report recommendation, the Office of Financial Management (OFM) developed a manual describing the major daily and monthly Statistical Analysis System (SAS) programs processed to generate reports and to create Journal Voucher text files for transfer to the Management Administrative Reporting System (MARS). However, a review of this manual during the FY 2005 audit revealed that the documentation was not being updated in a timely manner. Our examination of the 26 SAS programs documented in the manual revealed there were significant program code changes made to 10 of those SAS programs, or 38.5 percent, for which the manual had not been updated.

Without up-to-date maintenance of program documentation, individuals responsible for reviewing, testing, and approving program code changes are not being provided with sufficient information to make educated business decisions.

The agency has incorporated the procedure of updating the SAS program manual documentation within the Program Change Request process. This process is necessary to enhance OFM personnel's ability to maintain and update systems efficiently and to identify and correct programming defects.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-18: The Finance And Administration Cabinet Should Ensure The
Statistical Analysis System Manual Is Kept Up-To-Date (Continued)**

Recommendation

We recommend that OFM update the SAS program manual to reflect the most current versions of all programs. Further, the SAS program manual should be properly updated anytime changes are made to programs in the future.

The auditors are aware of the planned development of a new system, which will take the place of the SAS current programs. However, all current SAS documentation should be made as up to date as possible to ensure that any support placed on these for the new programs is proper.

Management's Response and Corrective Action Plan

The Office of Financial Management agrees that the SAS Program Manual should be kept up to date. The manuals are being updated this week (March 14-25, 2005) to the most current SAS Programs. In the future, changed programs will be updated in the manual in a timely manner.

Although there have been significant improvements by the Office of Financial Management (OFM) that have strengthened controls over the system programmer's access to the production environment, OFM does not employ proper segregation of duties between the programming and operation functions. We have noted this internal control weakness for the last three audits.

During the FY 2003 audit, the programmer was functioning as the operator for the Statistical Analysis System (SAS) programs used within the Commonwealth's Cash and Investments System, by submitting production programs for processing on a routine basis. This situation improved within FY 2004, so that within FY 2005 a program scheduler called LanBatch has been used to perform daily processing, which is overseen by the system librarian. However, the programmer is still processing the monthly programs within production.

Employing strong segregation of duty controls decreases the opportunity for unauthorized modification to files and programs, and decreases the likelihood of errors or losses occurring because of incorrect use of data, programs, and other resources.

Computer programmers should not have direct access to production version of the program source code or be able to directly affect the production environment. Controls should be established to ensure that the computer programmer does not intentionally or unintentionally introduce unauthorized or malicious source code into the production environment. Smaller organizations that cannot easily

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-18: The Finance And Administration Cabinet Should Ensure The Statistical Analysis System Manual Is Kept Up-To-Date (Continued)

Management's Response and Corrective Action Plan (Continued)

segregate programmer duties from computer operator duties should implement compensatory controls to supervise programmer activities to ensure only properly tested and authorized programs are migrated into production.

Due to a change in the timing of the auditor's review of certain IT processes and controls, the testing of FY 2005 IT processes and controls was conducted prior to the agency having an opportunity to remedy the issues identified in the FY 2004 report comments.

FINDING 05-FAC-19: The Finance And Administration Cabinet Should Improve Segregation Of Duty Controls

Although there have been significant improvements by the Office of Financial Management (OFM) that have strengthened controls over the system programmer's access to the production environment, OFM does not employ proper segregation of duties between the programming and operation functions. We have noted this internal control weakness for the last three (3) audits.

During the FY 2003 audit, the programmer was functioning as the operator for the Statistical Analysis System (SAS) programs used within the Commonwealth's Cash and Investments System, by submitting production programs for processing on a routine basis. This situation improved within FY 2004, so that within FY 2005 a program scheduler called LanBatch has been used to perform daily processing, which is overseen by the system librarian. However, the programmer is still processing the monthly programs within production.

Employing strong segregation of duty controls decreases the opportunity for unauthorized modification to files and programs, and decreases the likelihood of errors or losses occurring because of incorrect use of data, programs, and other resources.

Computer programmers should not have direct access to production version of the program source code or be able to directly affect the production environment. Controls should be established to ensure that the computer programmer does not intentionally or unintentionally introduce unauthorized or malicious source code into the production environment. Smaller organizations that cannot easily segregate programmer duties from computer operator duties should implement compensatory controls to supervise programmer activities to ensure only properly tested and authorized programs are migrated into production.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-19: The Finance And Administration Cabinet Should Improve Segregation Of Duty Controls (Continued)**

Due to a change in the timing of the auditor's review of certain IT processes and controls, the testing of FY 2005 IT processes and controls was conducted prior to the agency having an opportunity to remedy the issues identified in the FY 2004 report comments.

Recommendation

We recommend that OFM not allow the programmer to process the monthly programs. This function should be performed by another person within the agency or with an automated scheduler that will allow for the necessary flexibility of the timing and repetition of production processing.

Management's Response and Corrective Action Plan

Beginning in approximately December 2005, the programs will be included in LanBatch processing. This will result in the programmer no longer having access to the month end programs. Prior to the programs being included in LanBatch, several things need to occur. 1) The new program will have to pull from the old program to run July month end, 2) OFM will be upgrading to Access 2003 after the new program is put into production, which will result in parallel processing of Access 2003 and Access 1997 programs for at least two months. Once parallel processing of Access 2003 and Access 1997 has been completed and Access 2003 is working properly, the new program will be placed in LanBatch.

The only time the programmer will have access to the programs is to make programming changes which have been requested and approved on a Program Change Request. In addition, the programmer will then place the new program into a separate file location. The supervisor of the Accounting/IT Group will then review the new program and once approved, the supervisor will instruct the Librarian to move the files to the Library. The programmer will not have access to the program files after they are moved for Supervisor approval.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-20: The Finance And Administration Cabinet Should Review And Strengthen Current Procedures For System Assurance Between PD And Advantage

Our review of the system assurance process designed to assure completeness and synchronicity between Procurement Desktop (PD) and Advantage Financial (Advantage) data for FY 2005 revealed that the process needs to be both strengthened and consistently applied.

During the prior year's audit, we informed the Finance and Administration Cabinet (FAC) of concerns we had about the maintenance of the Out of Sync log, which is used to document out of synchronization conditions, resolution, and associated transaction ID's between the data of PD and Advantage. We found that the log either did not contain all errors found in the PD to Advantage system assurance reports or did not indicate prompt resolution of errors.

Our testing indicated that FAC still did not adequately or consistently document all errors reported within the FMPSAPDA, FMPSAPVA, FMPSARQA, and FMPSAPOA system assurance reports. A sample of reports for ten dates within the time period July 1, 2004 through April 6, 2005, revealed 139 errors that were expected to be included on the Out of Sync log. Of these 139 errors, only 21 were appropriately documented on the date of occurrence along with information that documented the cause of the problem and the resolution. Twenty-five other transactions revealed the errors were documented on the log prior to the date on the report in our sample with no indication of cause and/or resolution to corroborate FAC's monitoring the status of such errors. Specific to these 25 transactions, the Out of Sync log provided no indication of the date of resolution or the length of time required to remove the transactions from the associated system assurance report. Finally, 93 transactions were not documented at all on the log. FAC identified 89 of these transactions as being related to cancelled pre-encumbrance documents within PD from the previous fiscal year. These transactions would not require a corresponding action in Advantage. However, no documentation to this effect was provided on either the Out of Sync log or on any report notes maintained by FAC.

It is ultimately FAC's responsibility to ensure that all data that should be transferring between PD and Advantage modules is complete and appropriately reflected in both modules. These procedures should be sufficient to ensure that all instances of exceptions are documented, investigated, and resolved.

Without adequate controls in place to review the PD and Advantage completeness and synchronization process, there is no assurance that data is accurate and complete within both modules. If errors noted within the PD to Advantage system assurance process are not appropriately documented and resolved in a timely fashion, data flow between PD and Advantage could be compromised. Furthermore, an adequate audit trail is not documented concerning efforts to resolve any errors.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-20: The Finance And Administration Cabinet Should Review And Strengthen Current Procedures For System Assurance Between PD And Advantage (Continued)

Sound system assurance procedures and data output controls help to ensure that all errors are properly reviewed and corrected in a timely fashion. Similarly, thorough documentation of the error correction process is essential in detailing procedures used to correct errors and in identifying system-processing problems that might potentially require a programming change.

Recommendation

We recommend that FAC review and strengthen the current procedures in place for system assurance between PD and Advantage to ensure they are sufficient, adequately performed, and consistently applied. Further, we recommend the following specific procedures:

- Expected recurring errors not requiring a corresponding action to take place, such as the cancelled pre-encumbrances in PD, should either be reflected on the system assurance report or monitored on the Out of Sync log
- All error transactions that are corrected but will remain on the system assurance report until a specific date, such as hard close, should be documented on the Out of Sync log along with the anticipated date of removal
- All other errors should be monitored on the Out of Sync log along with comments concerning actions taken to resolve the error and date of resolution
- All errors requiring an action should be corrected in a timely fashion.
- To help ensure errors are corrected within a reasonable amount of time, the Out of Sync log could be updated to include an Information Systems Department contact so that FAC could more easily follow up on any actions taken

Management's Response and Corrective Action Plan

The majority of the items noted referred to RQ documents for which no action is taken in the systems assurance by design at the end of the year as these entries are canceled in PD and not rolled forward to Advantage in the new year. Of the remaining 29 documents noted, 2 documents were inadvertently left off the log, although the corrections were made in a timely fashion. The remainder of the incidents were either intended because that's how the process works, idiosyncrasies of the reports under certain conditions, or had no accounting impact. We will do better to make notes on the log for those items that are intended

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-20: The Finance And Administration Cabinet Should Review And Strengthen Current Procedures For System Assurance Between PD And Advantage (Continued)

Management's Response and Corrective Action Plan (Continued)

to be there without action. All actions on out of sync conditions are taken by the Controller's Office unless they represent an unknown condition for which a new script would need to be written to fix the condition or ignore it from the SA report.

FINDING 05-FAC-21: The Finance And Administration Cabinet Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose

During the security vulnerability assessments for FY 2005 for machines administered by the Finance and Administration Cabinet (FAC), our examination revealed one machine with a port open that may not have a specific business-related purpose.

One machine was found to be running an outdated version of ArGoSoft FTP Server for Windows NT/2000/XP via port 21. ArGoSoft has released an updated version of their file transfer protocol (FTP) server to address security vulnerabilities. These issues include three buffer overruns when handling overly long commands of a certain type, a file enumeration issue involving one command type and user database corruption denial of service attacks via one other command type. This port should be reviewed to ensure business necessity.

The existence of unnecessary open ports increases potential security vulnerabilities and is an invitation for intruders to enter the system. Further, improperly secured services can provide excessive information to unauthorized users.

The existence of open ports is an invitation for intruders to enter your system. To minimize the risk of unauthorized access to a machine, only necessary, business-related ports should be open. Further, the application residing at these ports should be secured to the extent possible.

Recommendation

We recommend that the noted open port be reviewed on this machine housing FAC resources to ensure there is a specific business-related purpose requiring the port to be open. If not required, then that port should be closed. If the port is necessary, then FAC should ensure adequate logical security controls are implemented to prevent unauthorized access including installation of updated versions for the service.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-21: The Finance And Administration Cabinet Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose (Continued)

Management's Response and Corrective Action Plan

Port 21 Machine was a Production FTP Server that has since been consolidated and taken out of service.

FINDING 05-FAC-22: The Finance And Administration Cabinet Password Policy Should Be Consistently Applied To Local Workstations

During our security vulnerability testing performed on Finance and Administration Cabinet (FAC) we identified machines that did not adhere to the agency-established password policies and contained various user accounts with password ages that exceeded the established password policy.

Within the domain maintained by FAC, we found six of 19 machines examined had default settings from the original setup installation, which did not agree with the standards set by FAC and COT. The same six machines were cited in the FY 2004 audit as not being in compliance with the established password policy.

We also found administrator accounts on 19 machines that had passwords ranging in age from 104 days to 307 days old, which is significantly older than the password policy of 31 days established for each machine. Eighteen of these machines had been identified as having an administrator account in exception during the FY 2004 audit. Finally, we noted a user account on a primary domain controller (PDC) that had a password age of 104 days and had never been used to log onto the machine.

If the agency's established password policy is not properly enforced, it increases the likelihood that non-compliant user accounts could be compromised, as well as increasing the risk to underlying data accessibility of the compromised accounts.

Intruders often use inactive accounts to break into a network. If an account has not been used for a reasonable period of time and is determined to be unnecessary, the account should be disabled until it is needed. This action will minimize the possibility that an unauthorized user will access the account.

For security purposes, detailed information concerning the specific machines or user accounts that contributed to these findings has been intentionally omitted from this comment. However, these issues were thoroughly documented and communicated to the appropriate agency personnel.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-22: The Finance And Administration Cabinet Password Policy Should Be Consistently Applied To Local Workstations (Continued)

Recommendation

We recommend that FAC review all accounts on their machines periodically to determine whether the password ages adhere to the stated policy. Accounts not complying with policy should be evaluated to determine if they are still valid accounts that are required for a business-related purpose. If not, the accounts should be disabled or deleted depending on the necessity of reinstatement of the account. All accounts should be required to comply with established password policies.

Management's Response and Corrective Action Plan

It is the intention and direction of the Commonwealth Office of Technology that as assets become available and through consolidation efforts the password policies for local settings on workstations will be applied through Active Directory Group Security Policies, where settings will be applied across the board and not dependant on individual configuration setting.

FINDING 05-FAC-23: The Finance And Administration Cabinet Should Ensure All WEB Services On Its Machines Are Necessary

During the security vulnerability assessments, we determined service vulnerabilities with seven machines. Most of these machines had more than one issue involved. The vulnerabilities identified unnecessary access to functions that might be used by intruders for enumeration of servers, disclosure of information, execution of arbitrary code using default servlets and files, buffer overflow attacks, and security vulnerabilities resulting from the use of outdated versions of FrontPage.

These vulnerabilities appear to have resulted from outdated or unpatched software. These vulnerabilities can potentially be exploited, leading to exposure of sensitive system information or misuse of the services the web server provides.

If machines within a network have web services running that allow the noted security issues, the stability of the network could be compromised as these machines become more susceptible to unauthorized intrusion. Installed web services without a specific business purpose may subject the network to buffer overflow issues, execution of arbitrary commands to circumvent network security, and unauthorized access to network server volume files.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-23: The Finance And Administration Cabinet Should Ensure All WEB Services On Its Machines Are Necessary (Continued)

To assist in securing a network adequately, it is necessary to ensure all required web services have the most current security patch installed. Any unnecessary web service that does not have a known business function should be disabled.

For security purposes, detailed information concerning the specific machines or user accounts that contributed to these findings is being intentionally omitted from this comment. However, these issues were thoroughly documented and communicated to the appropriate agency personnel

Recommendation

We recommend that FAC take the necessary actions to ensure that web services on each identified machine are appropriately updated or patched, and take other security measures as needed to eliminate the specified web service vulnerabilities.

Management's Response and Corrective Action Plan

In response to web vulnerabilities related to the production web servers, we will be discussing these issues with the software vendor and attempt to eliminate any items that are not required, if applicable.

In the mean time certain aspects of this application are being updated and through attrition this process may be eliminated in future releases of this software.

The MSADC virtual directory will be removed from these servers. Action is being taken to remove un-necessary FrontPage from these servers.

FINDING 05-FAC-24: The Commonwealth Office Of Technology Should Inform Users Of The System Assurance Of Deficiencies Surrounding The Financial Analysis System

As noted in the previous four audits, there are no formal procedures in place for assuring the completeness or reliability of Financial Analysis System (FAS) application data. Formal procedures have not been developed for two reasons. First, FAS is made up of a combination of several types of programming languages, such as Java, Oracle, and SSL. This non-standard architecture makes it difficult to modify. Second, since FAS will no longer be used after MARS is upgraded on July 1, 2006, the Commonwealth Office of Technology (COT) development team has recommended that updates to FAS be kept to a minimum.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-24: The Commonwealth Office Of Technology Should Inform Users Of The System Assurance Of Deficiencies Surrounding The Financial Analysis System (Continued)**

Further, noted in the agency's response in the prior year comment, agencies that originally chose to use FAS were informed that the application could be useful for providing approximations, but were instructed to rely on their internal budget office for accurate financial data. However, the Finance and Administration Cabinet has not been able to provide documentation to support that this communication occurred or that additional communications concerning this issue were sent out to the agencies.

Without formalized system assurance procedures, there is no assurance that the data integrity within FAS has not been compromised. As a result, users cannot truly rely on the accuracy of the data within FAS.

Formalized system assurance procedures illustrate management's concern for strong data integrity within the system. COT is aware of the system assurance deficiencies that exist in the current FAS application. COT should take the necessary steps to inform those agencies using FAS that the data produced by the application is not reliable.

Recommendation

We recommend that COT immediately notify all agencies of the risks faced when relying on FAS data. The easiest way to inform users of this risk is to either display a message on the FAS website, prior to logging in or address the issue in a MARS News and Alerts Bulletin. Regardless of how this information is communicated to the user, COT should retain supporting documentation for audit purposes.

Management's Response and Corrective Action Plan

A notice will be placed on the FAS greeting page and a notification will be placed in the MARS newsletter.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-25: The Commonwealth Office Of Technology Should Formalize And Consistently Follow Established Procedures For Terminating An Employee

During our review of program modification procedures related to the Financial Analysis System (FAS) for FY 2005, we determined that the Commonwealth Office of Technology (COT) did not follow established, but informal, procedures for terminating an employee. The previous FAS Administrator was released early from his contract with the Commonwealth. Documentation relating to the FAS application should have been maintained and monitored by this employee. When reviewing the latest revision made to FAS, the auditor found that the program change documentation did not follow the new program modification process. Attempts to retrieve documentation and electronic mail (e-mails) associated with this change revealed little since the agency did not obtain job related information from the employee prior to his/her dismissal.

If employees are not terminated according to established procedures, both logical and physical security could be compromised.

Termination procedures that have been developed to protect the agency from data and property loss should be formalized to ensure that necessary procedures are performed consistently. Employees should be required to give up possession of their ID/badge, computer, e-mail account and archives, and all paper documentation prior to dismissal.

Recommendation

We recommend that COT formalize and consistently apply the established termination procedures. These procedures should consist of, but not be limited to, the following:

- The employee's access should be immediately restricted to 'Read only' to all applications and programs.
- The employee should forfeit his/her computer, e-mail account, e-mail archives, and all paper documentation.
- The employee's badge that permits entry to secure locations should be forfeited and associated access should be promptly revoked

Further, current employees should be reminded that copies of essential documentation should not be stored on local drives or within personal e-mail files or archives. Disciplinary actions should be established for instances where an employee is found to not be complying with the required behavior of storing essential documentation on the server or within a designated project area.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-25: The Commonwealth Office Of Technology Should Formalize And Consistently Follow Established Procedures For Terminating An Employee (Continued)

Management's Response and Corrective Action Plan

- *Arrangements had been made for the contractor's access to be restricted during the notification that he was being terminated. The vendor arrived to notify the contractor that he was being terminated at 4 pm. During that discussion period, the contractor's access to the systems he supported, email, and login were suspended/removed by COT personnel.*
- *The contractor's computer, e-mail account, archives and paper documentation were forfeit upon termination. The issue was that there was no record to be located because the contractor had violated established SOP by not properly entering information into the Change Control System, hence there was no record to be located to document the authorization to move code to production.*
- *Upon escorting the contractor from the building, the vendor returned the contractor's badge to his supervisor within 30 minutes. The contractor had no access to secure locations upon his termination and his accounts were locked to prevent access until they could be reviewed.*

The contractor had been made aware of not keeping essential documentation on his local machine. Again, the lack of documentation resulted from a lack of the contractor following established policies for Change Control. If he had not been terminated, discovery of this violation would have resulted in communication with his vendor as to his ability to follow procedure and would have resulted in disciplinary action.

FINDING 05-FAC-26: The Finance And Administration Cabinet Should Improve Property Officer Training To Ensure Capital Asset Additions Are Properly Recorded

The Commonwealth had capital asset additions totaling \$17,234,760 in FY 2005. We tested 76 additions and found 21 instances where the asset was not recorded at historical cost as documented by the invoice(s).

Summary of Errors:

Agency	Items with Errors	Net Difference
State Police	17	\$-37,859
Environmental Protection	1	\$ 1,770
Department for Public Health	3	\$ 606

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-26: The Finance And Administration Cabinet Should Improve Property Officer Training To Ensure Capital Asset Additions Are Properly Recorded (Continued)

We also noted nine instances at State Police of assets recorded as additions for FY 2005 that were actually purchased in a prior fiscal year and either not recorded in that year or deleted in error and restored. One item, SP90242000 Mobile Command Vehicle, was purchased in 2000, deleted in 2003 due to an input error, and then reentered in 2005. While it was appropriate to add these items, they should have been added with the actual acquisition date and not the date they were assigned or corrected.

Failure to record capital asset additions accurately at their historical cost resulted in either overstating or understating the asset. The cumulative effect of the known errors in FY 2005 was an overstatement of \$35,483.

These errors demonstrate that property officers are either unfamiliar with or have disregarded Capital Asset Policies and Procedures regarding the recording of additions at historical cost.

We also noted that the property officers at State Police reported that they did not have direct access to the invoices or other source documentation necessary to properly value capital assets for that agency.

FAC MARS training has provided property officers the mechanics of their job—how to complete FA (Fixed Asset) shells and make capital asset corrections or deletions. However, FAC has not provided the property officers with practical experience or knowledge in determining how to value capital assets or recording the actual acquisition date.

Capital assets should be valued at cost including all ancillary charges necessary to place the asset in its intended location and condition for use such as: transportation charges; installation charges; extended maintenance contract; any other normal or necessary cost required to place the asset in its intended location and condition for use.

Kentucky's Capital Assets Procedures as determined by the Finance and Administration Cabinet specifies that:

In determining the cost of an asset, component parts and all qualifying accessories should be included. Also included in the determination is the cost of freight, installation, and other auxiliary charges paid by the state, less any discounts. The trade-in allowance will not affect the cost of the asset. However, any training expenses incurred at the time of the asset purchase is included as part of the asset cost. (Fixed Assets Policies and Procedures Version 4 February 6, 2004)

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-26: The Finance And Administration Cabinet Should Improve
Property Officer Training To Ensure Capital Asset Additions Are Properly Recorded
(Continued)**

Recommendation

We recommend:

The Finance and Administration Cabinet provides training, to both existing and new property officers, which explains the methodology for valuing capital assets and gives practical examples that can be used for reference.

State agencies ensure that their property officers receive adequate training and are granted access to all records necessary to perform their required tasks.

Management's Response and Corrective Action Plan

As part of the implementation of a new accounting system, Finance is reviewing all processes and updating training materials. We will recommend that training be provided on fixed asset policies and procedures and includes practical examples for valuing capital assets and recording the acquisition date.

**FINDING 05-FAC-27: The Administrative Office Of The Courts Should Develop
Procedures To Ensure All Capital Assets Purchases Are Properly Coded And
Recorded In The Capital Asset Database**

As part of our central level capital assets audit, we tested expenditures coded to MARS object code E300 series to determine if these “non-capital” assets had been properly classified. We found fifty-six assets with a value of \$818,419 that the Administrative Office of the Courts (AOC) coded improperly and had failed to update MARS for the addition of these capital asset purchases. As a result of this omission, capital assets as reported in Kentucky’s Comprehensive Annual Financial Report were understated by this amount. Total capital assets for the Commonwealth’s governmental activities are \$18.7 billion.

AOC maintains its own separate capital assets database, Archibus. Following their annual inventory, AOC provides the Finance and Administration Cabinet reporting team an update from their Archibus system that provides additions, deletions, and corrections for AOC capital assets. AOC procedures were not sufficient to ensure that all capital asset purchases were properly coded, recorded in the capital asset database or tagged.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-27: The Administrative Office Of The Courts Should Develop Procedures To Ensure All Capital Assets Purchases Are Properly Coded And Recorded In The Capital Asset Database (Continued)

KRS 45.313 states: "Each budget unit shall maintain a current inventory of equipment having an original cost of five hundred dollars (\$500) or more. The inventory shall be available for examination by the Finance and Administration Cabinet at all times." All agencies are responsible for managing their capital assets in accordance with this statute, as well as complying with all state and federal regulations.

FAC Fixed Assets Procedures Manual states: "The ADVANTAGE Fixed Asset Module must be used for the tracking of all state assets with a cost of \$500 or more. This is not an option as FAP 120-20-01 states: "Agencies shall enter records into the fixed asset system for non-expendable property that promotes financial reporting, safeguarding of assets, and adequate insurance." The fixed asset system referred to in FAP 120-20-01 is the MARS ADVANTAGE Fixed Asset Module."

Recommendation

We recommend AOC amend their capital asset procedures to include testing of their annual MARS update prior to submission to the Finance and Administration Cabinet to ensure that all additions, deletions, and corrections have been included.

Management's Response and Corrective Action Plan

Finance will work with AOC to develop procedures to ensure that fixed asset records are appropriately updated

FINDING 05-FAC-28: The Finance And Administration Cabinet Should Develop Procedures To Improve Accounting For Real Property

Finance and Administration Cabinet (FAC) procedures require agencies to annually perform a physical inventory of equipment and vehicles and review real property holdings. Real property is included in the physical observation of inventory every five years, and 2005 was observed this year.

As a part of the audit of capital assets, auditors observed capital assets valued at over \$279 million at 54 locations throughout the Commonwealth representing 12 state agencies. Total capital assets for Kentucky were \$18.7 Billion.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-28: The Finance And Administration Cabinet Should Develop Procedures To Improve Accounting For Real Property (Continued)

During our observations we noted the following weaknesses or errors:

- Real property identified during observations as having been destroyed or disposed of remained in capital asset tables' years after destruction. For example, the following were listed as included as capital assets at Parks prior to the 2005 inventory.

FA NUMBER	DESCRIPTION	YR Destroyed/ Disposed	Value
PK000030366012	KY Dam TV Upgrade	1998	\$55,845
PK000030366999D	Kentucky Dam Auditorium	1996	\$54,581
PK000030353016	Pine Mountain State Park Golf Pro Shop	2001	\$19,000

All the buildings listed above are now properly recorded in MARS as disposed. Parks has requested MARS be updated to record the disposal of additional real properties as supported by their inventory observation, but has not yet provided FAC with sufficient documentation to support these requests.

- Real property not listed or incorrectly listed as construction in process in MARS years after construction or acquisition per our observations at Parks and Military Affairs. In FY 2005 \$20.1 million of real property classified as buildings were added to MARS for these agencies that were actually acquired or construction completed in a prior year.

Examples:

FA NUMBER	DESCRIPTION	YR Completed	Value
MA000030436230A	Bluegrass Station Duplex	1997	\$ 83,000
MA000030389123B	BNGC USPFO Restrooms/ Showers	2000	\$ 55,557
MA000030389172B	Boone National Guard Office Space	2004	\$ 809,041
PK000030361001C	DH Lodge Renovation	2003	\$2,653,928
PK000030366001H	General Butler Convention Center	2003	\$5,637,628

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-28: The Finance And Administration Cabinet Should Develop Procedures To Improve Accounting For Real Property (Continued)

Several state agencies including Parks, Corrections, and Military Affairs have requested FAC to add additional real properties into MARS, but have not provided the necessary documentation to FAC to support their requests.

- Staff at one state park did not have knowledge of FAC inventory procedures and requested assistance from the auditor. It should be noted that auditors observing at other state parks noted improvements as far as following inventory procedures and entering corrections in MARS at the completion of their inventories.

State agencies have not effectively communicated with FAC when assets have been demolished, acquired or construction projects completed. While each agency can make additions, changes, and deletions of their equipment and vehicles, all changes to real property (land, buildings, improvements, and construction in process) must be entered by FAC. Changes to real property along with supporting documentation must be communicated to FAC. These weaknesses have accumulated over several years and have resulted in an incomplete real property listing that does not reflect a complete record of the state's real property holdings. Failure to appropriately record the acquisition and disposal of real property in the state's accounting system has caused real property amounts to be incorrectly stated in the statement of net assets.

FAP 120-20-01 Personal Property and Vehicle Inventories I, General Provisions Pertaining To Fixed Asset Records states "A state agency shall maintain current records of physical properties and equipment and make appropriate additions and deletions to fixed asset records as property is acquired or disposed."

FAC procedures dictate that state agencies provide appropriate documentation of any change to real property to Statewide Accounting Services.

KRS 42.425 (2)(d) states the Department for Facilities and Support Services shall "Implement and maintain a comprehensive real property and facilities management database to include all state facilities and land owned or leased by the executive branch agencies, including any postsecondary institution."

Recommendation

FAC should implement the following:

- Improve real property procedures to ensure timely updates to the MARS capital asset tables;
- Implement procedures to ensure that capital assets are added to MARS upon receipt of the SAS-14 at the completion of the project rather than waiting for agency notification to record the asset.
- Consider increasing the frequency of real property inventories.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-28: The Finance And Administration Cabinet Should Develop Procedures To Improve Accounting For Real Property (Continued)****Recommendation**

- Develop procedures that would ensure each state agency property officer has had training on FAC inventory procedures.
- Follow-up on outstanding real property issues with all state agencies.
- Perform a comparison of their real property records with that of the FAC Department of Facilities and Support Services to ensure the accuracy of the real property listing.

Management's Response and Corrective Action Plan

FAC is currently reviewing policies; procedures and training related to fixed asset inventories and will consider the auditor's recommendations. The new eMARS accounting system upgrade that will be implemented July 1, 2006 may provide some opportunities for improvement in this area.

FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop Procedures To Comply With FAP-111-58-00

We randomly selected 40 ProCard expenditures from departments within the Finance and Administration Cabinet (FAC) and examined these purchases for compliance with FAP 111-58-00 *Procurement Card Program*. While reviewing these purchases, we noted the following noncompliances:

1. Our sample included 20 different cardholders. Of these, we noted three instances (three of 20 cardholders or 15%) where multiple employees shared individual ProCards.
2. FAC did not provide evidence that the \$10,000.00 card purchase limit for one employee was reasonable and necessary given the person's job responsibilities. A review of his ProCard purchases revealed that the most he purchased during any billing cycle was \$364.68 and that he only made 25 purchases totaling \$1,462.00 for all of FY 2005, (one of 20 cardholders or 5%).
3. We were unable to verify that sales tax was not paid on one invoice since the details of the purchase/charge were not included on the invoice (one of 40 sample items or 2.5%).
4. FAC did not maintain evidence documenting where cardholders inspected purchases of goods for accuracy and completeness (15 of 40 sample items or 37.5%).
5. FAC did not verify that documentation requirements were met for all purchases (mainly cardholder signatures on invoices) (17 of 40 sample items or 42.5%).

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop Procedures To Comply With FAP-111-58-00 (Continued)

6. FAC made one payment after the due date specified by the vendor invoice (one of 40 sample items or 2.5%).
7. FAC issued a payment to a Limited Liability Company for training (services) and did not record this expenditure to a 1099 reportable object code (one of 40 sample items or 2.5%).
8. The Agency Program Administrator did not sign one cardholder agreement (one of 20 cardholders or 5%).
9. We noted a handwritten vendor's invoice with multiple math errors, which resulted in the state being overcharged \$84.00. In addition, the vendor charged sales tax of \$24.39. On this transaction, the Commonwealth paid \$431.04 for a purchase that should have only been \$322.65, resulting in a \$108.39 (or 33.6%) overcharge. Also, for the above transaction, the cardholder did not sign the invoice.
10. In three instances, FAC employees returned purchases for cash instead of having a credit applied to the ProCard.
11. We found an instance where a finance charge was applied on a Bank One billing statement. We were informed that this finance charge was removed, but FAC could not produce documented evidence that the credit had been removed.
12. We noted two instances where FAC used the ProCard to pay for food. FAC provided evidence for the purpose of the purchase; however, they could not provide evidence-providing justification of the need or proof that the purchase benefited the Commonwealth.
13. We found one instance where the ProCard account number may have been compromised. The card number was written on an invoice for the shipment of a package, and another state employee (not the cardholder) sent this package. All writing on the package (including the ProCard number) was that of the non-cardholder. It appears the other employee (non-cardholder) had access to the ProCard account number.
14. FAC could not provide evidence that the Procurement Card Administrator conducted random physical reviews of the security of the procurement card by verifying cardholders had actual possession of their card in accordance with Section II D(2)(f) *Procedures of the Finance and Administration Cabinet Procurement Card Program Internal Procedures* manual.
15. FAC could not provide evidence of the issuance of formal reprimands for instances of noncompliance with program requirements (such as card sharing).
16. FAC could not provide evidence of the performance of a formal review of cardholder spending limits.
17. FAP 111-58-00 requires that the Finance and Administration Cabinet review the cardholder activity reports submitted by agencies monthly. Although this review is being performed by CRC each month, apparently referrals of noncompliances/late reports, etc. by CRC to the Internal Audit Division have not been followed up on or investigated further since December 2004.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop
Procedures To Comply With FAP-111-58-00 (Continued)**

Failing to purchase goods or services or monitor purchases in accordance with FAP 111-58-00 results in noncompliances with established Finance and Administration Cabinet procurement policies and procedures, which does not protect and promote good stewardship of taxpayer resources. Further, since these procedures were designed by the Finance and Administration Cabinet, failing to follow these requirements also sets a poor precedent for other agencies to follow, which could result in increased misuse of taxpayer funds.

Section 2 of FAP 111-58-00 states, “An individual card embossed with an employee’s name shall be used exclusively by that employee and shall not be shared or loaned to other employees.”

Section 21(d) of FAP 111-58-00 states, “The Office of the Controller annually shall review . . . spending limits for cards.”

Section 10 of FAP 111-58-00 states, “A cardholder shall, as an agent of the Commonwealth, ensure the proper use of the Commonwealth’s tax exempt registration number.”

Section 11 of FAP 111-58-00 states, “A cardholder shall properly inspect all shipments.”

Section 12 of FAP 111-58-00 states, “Receipts for source documentation shall include the vendor’s name, date of purchase, description of each item purchased, price of each item purchased, total cost, cardholder name or card number, and signature of cardholder or designee.”

Section 15(g) of FAP 111-58-00 states that the payment process should be coordinated “to ensure that timely remittance is made” for purchases.

Section 20 of FAP 111-58-00 states, “An agency shall ensure that all 1099 reportable purchases are coded to the proper object codes.” In addition, the IRS Form 1099-MISC instructions state that 1099-MISC forms should be sent for “Payments for *services* performed for a trade or business by people not treated as its employees.”

Section 18 of FAP 111-58-00 states, “An agency head shall either serve as, or appoint an employee of the agency to serve as, the authorized signer with responsibilities including, but not limited to giving instruction to the authorizing bank, and signing each Procurement Card Cardholder Agreement on behalf of the agency as provided by the Finance and Administration Cabinet.”

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop
Procedures To Comply With FAP-111-58-00 (Continued)**

Payments should be checked for accuracy prior to payment. In addition, section 10 of FAP 111-58-00 states, "A cardholder shall, as an agent of the Commonwealth, ensure the proper use of the Commonwealth's tax exempt registration number."

Section 12 of FAP 111-58-00 states, "Receipts for source documentation shall include the vendor's name, date of purchase, description of each item purchased, price of each item purchased, total cost, cardholder name or card number, and signature of cardholder or designee."

Section 11 of FAP 111-58-00 states, "In case of returns, a cardholder shall coordinate the return directly with the supplier and contact the agency program administrator with any unresolved issues. Returns for cash are not permitted."

Section 19 of FAP 111-58-00 states, "An agency shall process payments in the state's procurement system in sufficient time to pay the issuing bank."

Section 17(e) of FAP 111-58-00 states, "Purchases of food or beverage shall be accompanied by documentation explaining the reason for the purchase, justification of need, and proof that they benefited the Commonwealth. Examples of this documentation include, but are not limited to, prior approval memo, meeting minutes and board calendars."

Section 2 of FAP 111-58-00 states, "An individual card embossed with an employee's name shall be used exclusively by that employee and shall not be shared or loaned to other employees."

Section 17(i) of FAP 111-58-00 states, "Each agency shall establish a process to examine and monitor compliance with this policy by cardholders, organizational unit's card custodians, card users, authorized signers and agency procurement card administrators. The results of reviews shall be documented and retained."

Section 17(g) of FAP 111-58-00 states, "Each agency shall take appropriate disciplinary actions whenever any violation of this policy is identified."

Section 21(d) of FAP 111-58-00 states, "The Office of the Controller annually shall review . . . spending limits for cards."

Section 21(c) of FAP 111-58-00 states, "Monthly, the Finance and Administration Cabinet shall review reports and documentation submitted by agencies. Based on card usage, the cabinet may determine that an agency or cardholder shall be subject to additional review."

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop Procedures To Comply With FAP-111-58-00 (Continued)

Recommendation

Based upon the results of our testing, we recommend that the Finance and Administration Cabinet conduct an extensive review of the ProCard purchasing and monitoring procedures and also conduct a mandatory training session of cardholders and ProCard administrators to describe the documentation requirements of FAP 111-58-00 for ProCard purchases.

In addition, the Finance and Administration Cabinet should take appropriate steps to comply with the FAP requirements, including:

- Issuing written reprimands for card sharing and other cardholder violations
- Reviewing cardholder spending limits for reasonableness
- Reviewing purchases to ensure sales tax is not charged
- Taking the necessary steps to ensure that payments for training to non-employees are appropriately coded to 1099 reportable object codes
- Reviewing invoices for mathematical accuracy to ensure the Commonwealth isn't overcharged (and also recoup overcharges from vendors).
- Periodically (at least quarterly) conducting physical reviews (and maintaining documentation of the reviews) of a random sample of cardholder ProCard to ensure they have actual possession of their card.
- Following up on CRC referrals of cardholders who are not in compliance with ProCard documentation and reporting requirements as some of these instances might necessitate additional review or investigation.

Management's Response and Corrective Action Plan

The Finance and Administration Cabinet has reviewed the noncompliance issues and recommendations listed above. The Office of Administrative Support will issue a reminder to all cardholders outlining their responsibilities as a cardholder including issues that came up during the audit and any changes that will take effect under the new contract. We will continue to meet with new cardholders and stress the issues that were found in the audit and the other requirements in FAP 111-58-00.

Regarding specific issues of concern:

1, 3, 4, 5, 9, 10, 12, 13. Will be part of the document sent to the cardholders.

2 and 16. Before issuing the cards under the new contract, past utilization of the cards will be reviewed for spending limits.

6 and 11. Steps will be taken to ensure that ProCard payments are made in a timely manner.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop
Procedures To Comply With FAP-111-58-00 (Continued)**

Management's Response and Corrective Action Plan (Continued)

7. *Statewide Accounts has changed the E133 minor object code to flag it as 1099 reportable.*

8. *Review will be made of the documents to ensure they are complete.*

14. *The Internal Control Procedures Manual will be reviewed and updated based on the requirements of the new contract and the updated FAP, which is currently under review.*

15. *Disciplinary action will be taken when deemed appropriate.*

17. *The Office of Policy & Audit is not required to follow-up on each instance of an agency not submitting a monthly report on time. More recently, it focused instead, on its overall audit of the ProCard Program, which was released 10/03/05. It covered the 3rd quarter of CY04, and included a sample of 129 transactions (e.g. 99 random and 30 judgmental). Our judgmental sample came from our review of agency monthly activity reports, which is something APA implies we do not do. Also, the preamble of the report discusses other actions the Finance & Administration Cabinet has taken to strengthen oversight, which includes a review of agency spending limits, which APA states in #17 has not been accomplished. We are in the process of revising FAP 111-58-00 as a result of the audit, as well as the result of moving forward with our conversion to PNC. This new vendor offers an on-line system (VIS) that will become available to administrators as sites are established and to cardholders as cards are established. Administrators will be able to view all card information and transactions online for their respective agencies, as well as cardholders for their transactions. In addition, FAC will be able to view all of this information for oversight purposes. As a result, much of the wording in the FAP related to the submission, review, and action re: monthly activity reports is not needed. For the future, the Office of Policy and Audit will use this new automated system as a way to monitor agency compliance with the FAP. APA's last recommendation will not be applicable, since we will have access to this system.*

The Finance and Administration Cabinet will continue to review the ProCard process as we transition to the new contract and E-MARS.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-29: The Finance And Administration Cabinet Should Develop
Procedures To Comply With FAP-111-58-00 (Continued)****Auditor's Reply**

- 15) Section 17(g) of FAP 111-58-00 states that appropriate disciplinary action should be taken whenever any violation of the FAP is identified. During the audit, we were informed that no disciplinary action was taken for ProCard violations. This section of the FAP provides that "the agency shall, at a minimum, issue an appropriate reprimand, including specific notice that a second violation will result in revocation of card privileges and further potential disciplinary action up to and including dismissal". Part III of the Cabinet's ProCard Internal Control Plan provides that "Violations subject to disciplinary action shall include, but not limited to card sharing . . . personal usage". Instances of card sharing and personal usage were identified during the audit and were communicated to FAC. We request FAC document final agency actions to address the noted violations for review during the FY 2006 audit.
- 17) Our understanding is that CRC reviews monthly activity reports for timely submission and completeness of signatures and refers individuals to the Office of Policy and Audit. Based upon the information provided during the audit, no action has been taken by the Cabinet on referrals since December 2004.

**FINDING 05-FAC-30: The Finance And Administration Cabinet Should Develop
Procedures To Protect The Security Of ProCards**

We randomly selected 40 ProCard expenditures from within the Finance and Administration Cabinet (FAC) and examined these purchases for compliance with FAP 111-58-00 *Procurement Card Program*. As part of this testing, we verified the location of the ProCard for each cardholder in our sample. While verifying the card location, we visited the offices of cardholders unannounced and asked to see their ProCard. For the first four cardholders, we provided our APA identification badge to verify that we were APA Auditors and then asked to see the cardholder's ProCard. For the remaining verifications (approximately 80%), the cardholder provided their ProCard to the auditor without any verification or identification other than a verbal introduction and request. No previous notice had been given to the cardholder of our visit.

Many cardholders within FAC have large ProCard spending limits and some of the cardholders we tested have limits up to \$50,000.00. Therefore, when cardholders expose their ProCard credit card number, expiration date, and three-digit security number to a stranger who doesn't provide identification, this presents an unnecessary risk that sensitive FAC ProCard numbers could be stolen, which could result in a misuse of taxpayer resources.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or
Instances of Noncompliance*****FINDING 05-FAC-30: The Finance And Administration Cabinet Should Develop
Procedures To Protect The Security Of ProCards (Continued)**

Good internal controls dictate that cardholders take appropriate steps to keep their ProCard numbers secure. In general, cardholders should not reveal credit card numbers, expiration dates, and three digit security numbers to anyone. Under these circumstances, since the information requested was of a sensitive nature, cardholders should have requested proof (such as an official APA identification badge) that the APA representative was a valid employee of the Commonwealth and should not have provided their cards without this verification.

Recommendation

We recommend that FAC remind cardholders of their responsibility to safeguard their ProCard number. Cardholders should take adequate steps to protect the information (card number, expiration date, three digit security code) on their card to prevent it from being stolen, which could lead to a misuse of taxpayer funds.

Management's Response and Corrective Action Plan

The Finance and Administration Cabinet will caution all cardholders to safeguard their ProCard. Further, cardholders will be reminded to require valid identification if someone is requesting to see their card or asks for their card number.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Reportable Conditions</u>					
<i>(1) Audit Findings that have been fully corrected:</i>					
FY 04	04-FAC-1	The Finance And Administration Cabinet Should Develop And Implement A Formal Policy To Govern Security Of The Management Administrative And Reporting System Interface Files	N/A	0	Resolved during FY 05.
FY 04	04-FAC-2	The Office Of Financial Management Should Implement Procedures To Ensure The Data Provided For The Year-End Investment Income Accrual Is Accurate And Complete	N/A	0	Resolved during FY 05.
FY 04	04-FAC-3	The Finance And Administration Cabinet Should Ensure All Agencies Conduct Accurate And Timely Fixed Asset Inventory Counts	N/A	0	Resolved during FY 05
FY 03	03-FAC-2	The Finance And Administration Cabinet Should Strive To Ensure That All State Agencies Conduct Accurate And Timely Fixed Asset Inventory Counts	N/A	0	Resolved during FY 05.
FY 03	03-FAC-5	The Finance And Administration Cabinet Should Strengthen Develop And Implement Formal Policy And Procedures To Govern Security Of The Management Reporting And Accounting System Interface Files	N/A	0	Resolved during FY 05.
<i>(2) Audit Findings not corrected or partially corrected:</i>					
FY 04	04-FAC-4	The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investment System	N/A	0	See 05-FAC-1
FY 04	04-FAC-5	The Finance And Administration Cabinet Should Strengthen Logical Security Procedures Surrounding The Complete Asset Management Reporting And Accounting System	N/A	0	See 05-FAC-2
FY 03	03-FAC-6	The Finance And Administration Cabinet Should Develop And Apply Formal System Development Life Cycle Procedures For The Commonwealth's Cash And Investment Statistical Analysis System Programs	N/A	0	See 05-FAC-1
FY 03	03-FAC-7	The Office Of Financial Management Should Improve Segregation Of Duty Controls	N/A	0	See 05-FAC-2 05-FAC-17 05-FAC-19

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Reportable Conditions (Continued)</u>					
<i>(2) Audit Findings not corrected or partially corrected (Continued):</i>					
FY 02	02-FAC-3	The Finance And Administration Cabinet Should Develop And Consistently Apply Formal Change Management Procedures For The Commonwealth's Cash And Investment Statistical Analysis System Programs	N/A	0	See 05-FAC-1
FY 02	02-FAC-4	The Office Of Financial Management Should Improve Segregation Of Duty Controls	N/A	0	See 05-FAC-2 05-FAC-17 05-FAC-19
FY 01	01-FAC-3	The Office Of Financial Management Should Improve Control Procedures Over Modifications To System Programs	N/A	0	See 05-FAC-1
FY 00	00-FAC-6	The Office Of Financial Management Should Improve Control Procedures Over Modifications To System Programs	N/A	0	See 05-FAC-1

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings to report for this section.

(4) Audit finding is no longer valid or does not warrant further action:

There were no findings to report for this section.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Material Weaknesses

(1) Audit findings that have been fully corrected:

There were no findings to report in this section.

(2) Audit findings not corrected or partially corrected:

There were no findings to report for this section.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings to report for this section.

(4) Audit finding is no longer valid or does not warrant further action:

There were no findings to report for this section.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(1) Audit Findings that have been fully corrected:</i>					
FY 04	04-FAC-7	The Office Of Financial Management Should Review Transactions To Ensure That Revenue Is Recognized Properly In The Management Accounting And Reporting System	N/A	0	Resolved during FY 05.
FY 04	04-FAC-8	The Office Of Financial Management Should Ensure That The Ending Accrued Earnings Is Updated In The Month-End File When Adjustments Are Made To An Account's Distribution	N/A	0	Resolved during FY 05.
FY 04	04-FAC-11	The Finance And Administration Cabinet Should Work In Conjunction With The Governor's Office Of Technology To Strengthen Procedures Surrounding Procurement Desktop Audit Logging	N/A	0	Resolved during FY 05.
FY 04	04-FAC-12	The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 04	04-FAC-13	The Finance And Administration Cabinet Should Improve Logical Security Measures Over The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 04	04-FAC-16	The Finance And Administration Cabinet Should Improve Policies And Procedures For The Statewide Cost Allocation Plan	N/A	0	Resolved during FY 05.
FY 03	03-FAC-12	The Finance And Administration Cabinet Should Continue To Work In Conjunction With The Governor's Office Of Technology To Implement Logging and Audit Features Within Procurement Desktop	N/A	0	Resolved during FY 05.
FY 03	03-FAC-13	The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 03	03-FAC-14	The Finance And Administration Cabinet Should Improve Logical Security Measures Over The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 02	02-FAC-17	The Finance And Administration Cabinet Should Work In Conjunction With The Governor's Office Of Technology To Strengthen Procedures To Implement Logging And Audit Features Within Procurement Desktop	N/A	0	Resolved during FY 05.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters (Continued)</u>					
<i>(1) Audit Findings that have been fully corrected (Continued):</i>					
FY 02	02-FAC-18	The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 02	02-FAC-19	The Finance And Administration Cabinet Should Improve Logical Security Measures Over The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 01	01-FAC-12	The Finance And Administration Cabinet Should Improve Logical Security Measures Over The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 01	01-FAC-13	The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 01	01-FAC-15	The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System	N/A	0	Resolved during FY 05.
FY 00	00-FAC-7	The Finance And Administration Cabinet Should Work In Conjunction With The Governor's Office Of Technology To Implement Logging And Audit Features Within Procurement Desktop	N/A	0	Resolved during FY 05.
<i>(2) Audit Findings not corrected or partially corrected:</i>					
FY 04	04-FAC-6	The Finance And Administration Cabinet Should Ensure Proper Classification And Categorization Of Investments In The Cash And Investment Note	N/A	0	See 05-FAC-12, Comment is now a Material Reportable Condition.
FY 04	04-FAC-9	The Finance And Administration Cabinet Should Establish And Apply A Security Policy Concerning Local Workstations	N/A	0	See 05-FAC-22.
FY 04	04-FAC-10	The Finance And Administration Cabinet Should Develop Formal Procedures For System Assurance Efforts Concerning The Financial Analysis System	N/A	0	See 05-FAC-24.
FY 04	04-FAC-14	The Finance And Administration Cabinet Should Improve Monthly Reconciliation Procedures	N/A	0	See 05-FAC-17.
FY 04	04-FAC-15	The Finance And Administration Cabinet Should Improve Segregation Of Duty Controls	N/A	0	See 05-FAC-19.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters (Continued)</u>					
<i>(2) Audit Findings not corrected or partially corrected (Continued):</i>					
FY 03	03-FAC-11	The Finance And Administration Cabinet Should Develop And Implement Formal Written Policies And Procedures Concerning Security Of The Financial Analysis System	N/A	0	See 05-FAC-24.
FY 02	02-FAC-16	The Finance And Administration Cabinet Should Develop Formal Procedures For System Assurance Efforts Concerning The Financial Analysis System	N/A	0	See 05-FAC-24.
FY 01	01-FAC-14	The Finance And Administration Cabinet Should Develop Formal Procedures For System Assurance Efforts Concerning The Financial Analysis System	N/A	0	See 05-FAC-24.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings to report for this section.

(4) Audit finding is no longer valid or does not warrant further action:

There were no findings to report for this section.

